The classification of entities, and the meaning of "tax transparency", in United Kingdom tax law

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The classification of entities, and the meaning of "tax transparency", in United Kingdom tax law

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Summary (English)

The classification of entities, and the meaning of "tax transparency", in United Kingdom tax law

This thesis is broken down as follows:

1. Following an introduction (including research questions), the first chapter explores the main UK tax law definitions of those legal persons which are relevant for direct tax purposes. In particular, it explores the law, practice and tax authority guidance (such as it is) for classifying entities formed outside the UK. In so doing, it considers in detail the distinction between a "partnership" and a "company" for UK tax purposes, and the problems this raises. Finally, it offers a critique of the relevant law, practice and administrative guidance.
2. The second chapter considers the UK criteria for defining certain kinds of trust for UK tax purposes, including non-UK entities with trust-like characteristics such as foundations. It then considers to what extent the UK direct tax regime treats trusts and similar non-UK arrangements as "transparent". It also analyses the different kinds of "transparency" which may apply in relation to such trusts and arrangements for UK direct tax purposes. Finally, it critiques the relevant UK law and practice and makes some proposals for reform.
3. The third chapter begins with a more general discussion of what "transparency" may mean in the context of taxation (not just direct taxation) and taking into account the new "transparent entities" provision in Article 1(2) of the OECD Model 2017, and the related OECD Commentary. It concludes that there is no single concept of "transparency" for tax purposes (a conclusion already foreshadowed in the first two chapters) and that it may legitimately mean different things in different contexts. This conclusion paves the way for a detailed analysis of the varying degrees to which "transparency" is a relevant concept in relation to UK taxes which are not taxes on income and gain (notably Inheritance Tax, VAT and Stamp Duty Land Tax). Historically, there has been very little analysis of these issues y commentators. Again, the chapter critiques the relevant UK rules and makes reform proposals.
4. The fourth chapter explores the concept of tax "transparency" and entity classification of issues as they relate to double tax treaties and EU law. It begins with a survey of the strengths and weaknesses of the new Article 1(2) of the OECD Model 2017. It then goes on to discuss how, from limited beginnings, UK treaty policy has attempted to tackle these issues since the 1980's in its treaties relating to income and gain. It notes how the UK has been something of a follower, rather than a leader in this regard (see in particular the UK's last two treaties with the US and the latest UK treaty with France). The chapter then explores a number of areas where UK double tax treaties still raise problems of entity classification which are not addressed by rules resembling Article 1(2) of the OECD Model 2017 (e.g. some of the issues surrounding the Employment Income Article). Suggestions are made for improvements. The largely unaddressed problems of entity classification and tax "transparency" in the UK's estate and gift tax treaties are also considered. Lastly Chapter 4 considers the impact of EU law on questions of "entity classification" and "tax transparency". It concludes that in some respects the UK tax rules for classifying non-UK entities are not compliant with EU law.
5. The fifth chapter compares and contrasts the UK tax rules for classifying entities with the (very different) approach of the US Federal income tax, as well as the Dutch approach (which

is more akin to that of the UK). It seeks to pinpoint strengths and weaknesses of both the US and Dutch approach, when compared to the UK.

6. The last chapter begins by exploring why issues of entity classification and tax "transparency" matter when building a mature tax system, and not just in relation to the taxation of income and gain. This picks up themes discussed in the Introduction. It then sets out the answers to the research questions posed at the outset. It ends by proposing some more general reforms of the existing UK rules on entity classification and tax "transparency", taking into account changes identified in earlier chapters, as well as economic changes in recent decades. A number of alternative approaches to reform are recommended, some being less radical than others. One of the less radical approaches would involve partial adoption of the US approach, with anti-avoidance safeguards.

Summary (Dutch)

De classificatie van entiteiten en de betekenis van “fiscale transparantie” in het belastingrecht van het Verenigd Koninkrijk

Het proefschrift hierboven is als volgt opgebouwd:

1. Na een introductie (inclusief onderzoeksvragen), verkent het eerste hoofdstuk de definities van rechtspersonen die van belang zijn voor de directe belastingen. In het bijzonder wordt ingegaan op de wetgeving, praktijk en het beleid (met al zijn gebreken) betreffende de classificatie van entiteiten die buiten het VK tot stand zijn gekomen. Hierbij wordt in detail het onderscheid tussen een "partnership" en een "bedrijf" voor Britse belastingdoeleinden besproken, en de problemen die hieruit voortkomen. Ten slotte worden de relevante wetgeving, de praktijk en het geldende beleid kritisch bezien.
2. Het tweede hoofdstuk gaat in op de criteria voor het definiëren van bepaalde soorten trusts voor Britse belastingdoeleinden, inclusief niet-Britse entiteiten met trust-achtige kenmerken, zoals stichtingen. Vervolgens wordt besproken in hoeverre het directe belastingregime trusts en vergelijkbare niet-Britse organisaties als "transparant" aanmerkt. Ook worden de verschillende soorten van "transparantie" geanalyseerd die voor Britse directe belastingdoeleinden van toepassing kunnen zijn met betrekking tot dergelijke trusts en organisaties. Ten slotte worden de relevante Britse wetgeving en praktijk kritisch bezien en worden enkele voorstellen gedaan voor hervorming.
3. Het derde hoofdstuk begint met een meer algemene discussie van wat "transparantie" kan betekenen in de context van belastingheffing (niet slechts directe belastingheffing), waarbij acht wordt geslagen op de nieuwe "transparante entiteiten" bepaling van artikel 1(2) van het OESO-Modelverdrag 2017 en het gerelateerde OESO Commentaar. Geconcludeerd wordt dat er niet één concept is van "transparantie" voor belastingdoeleinden (een conclusie die de eerste twee hoofdstukken al deden vermoeden) en dat het woord legitiem verschillende betekenissen kan hebben in verschillende contexten. Deze conclusie maakt de weg vrij voor een gedetailleerde analyse van de verschillende maten waarin "transparantie" van relevantie is voor de belastingen van het VK die niet belastingen op inkomsten zijn (in het bijzonder de erfbelasting, omzetbelasting en het zegelrecht). Deze kwesties zijn in het verleden maar in weinig literatuurbronnen besproken. Wederom worden de relevante regels van het VK kritisch bezien en worden in dit hoofdstuk voorstellen gedaan voor hervorming.
4. Het vierde hoofdstuk verkent het concept van fiscale "transparantie" en de classificatie van entiteiten in de context van belastingverdragen en het EU-recht. Het hoofdstuk begint met een overzicht van de sterktes en zwaktes van het nieuwe artikel 1(2) van het OESO-Modelverdrag 2017. Vervolgens wordt besproken hoe het verdragsbeleid van het VK, vanuit een gelimiteerd beginstadium, sinds de jaren '80 heeft getracht om deze kwesties aan te pakken in belastingverdragen met betrekking tot belastingen naar het inkomen. Hierbij wordt opgemerkt dat het VK meer een volger dan een leider is geweest in dit verband (zie in het bijzonder de laatste twee verdragen van het VK met de VS en het laatste met Frankrijk). Het hoofdstuk gaat daarna in op een aantal gebieden waarin belastingverdragen gesloten door het VK nog steeds problemen veroorzaken voor de classificatie van entiteiten, welke

nog niet worden gedekt door regels lijkende op artikel 1(2) OESO-Modelverdrag 2017 (bijvoorbeeld sommige kwesties betreffende het inkomsten uit arbeid artikel). Er worden suggesties gemaakt voor verbetering. De meestal onbesproken gelaten problemen betreffende de classificatie van entiteiten en fiscale "transparantie" in de erf- en schenkbelastingverdragen gesloten door het VK worden ook besproken. Ten slotte gaat hoofdstuk 4 in op de impact van het EU-recht op vraagstukken inzake de "classificatie van entiteiten" en "fiscale transparantie". Geconcludeerd wordt dat in sommige opzichten de belastingregels van het VK voor de classificatie van niet-Britse entiteiten niet in overeenstemming zijn met het Unierecht.

5. Het vijfde hoofdstuk vergelijkt en contrasteert de belastingregels van het VK betreffende de classificatie van entiteiten met de (zeer verschillende) benadering van de federale inkomstenbelasting van de VS, evenals de Nederlandse benadering (die meer overeenkomt met de benadering van het VK). Het hoofdstuk beoogt vast te stellen wat de sterktes en zwaktes zijn van zowel de Amerikaanse als de Nederlandse benadering in vergelijking met het VK.
6. Het laatste hoofdstuk verkent allereerst waarom kwesties betreffende de classificatie van entiteiten en fiscale "transparantie" van belang zijn bij het bouwen van een volwassen belastingstelsel, en niet slechts in relatie tot de belastingheffing van inkomsten. Hierbij worden thema's opgepakt die in de introductie zijn ter sprake zijn gekomen. Vervolgens wordt een antwoord geformuleerd op de eerder gestelde onderzoeksvragen. Het hoofdstuk eindigt met een aantal algemene hervormingsmogelijkheden voor de bestaande regels van het VK over de classificatie van entiteiten en fiscale "transparantie", waarbij de veranderingen die geïdentificeerd zijn in eerdere hoofdstukken worden meegenomen, evenals economische veranderingen in de afgelopen decennia. Een aantal alternatieve benaderingen tot hervorming worden aanbevolen, sommige minder radicaal dan anderen. Eén van de minder radicale benaderingen zou een gedeeltelijke overname van de Amerikaanse benadering inhouden, met toevoeging van anti-ontwijkingsbepalingen.

Contents

Introduction

"Entity classification"

1.1 This thesis analyses how UK tax law identifies and defines taxable persons, other than natural persons (i.e. individuals). This process of identification and definition is henceforth referred to as "entity classification". A key question which forms part of this process is whether a legal person is a "company" or a "partnership" for UK tax purposes. This is mainly because "companies" are taxable persons in their own right whereas "partnerships" are not, at least for the purposes of taxing their own income and gains.[1]

"Entity classification" is not limited to identifying and defining only those persons who are potentially taxable in the UK, because they have the necessary physical link to the UK. It may also consist of identifying and defining persons outside the UK who have no such link. This is because other UK taxpayers may have relevant connections with such entities (e.g. a UK-resident person owning shares in a US corporation). In order to tax that other UK taxpayer correctly in respect of those connections, it is essential to understand what entity that taxpayer has a relevant connection with. Is it a company, a partnership, a trust, a simple contract or a co-ownership arrangement falling short of partnership or indeed something else?

"Tax Transparency"

1.2 Entity classification raises the important related question of whether a particular entity is "tax transparent" and if so, what precisely this means in a given context. Entities which are not "tax transparent" are typically referred to as "opaque". The answer to the transparency question often has a major impact on the UK taxation of the entity itself and of those with an interest in it. This is especially true when taxing interest holders in respect of income and capital gains which they derive from the entity.

"Tax transparency" is not a technical term. Rather it is, in particular, non-technical shorthand for situations where (i) an entity (e.g. a partnership or trust) is not a primary taxpayer in its own right in respect of income and gains[2]; and (ii) its members/those with a relevant interest in it are taxed on distributed and undistributed income and gain as if each such person were directly interested in the entity's underlying assets and revenues[3]. However, as will become clearer, "tax transparency" is not a concept limited to taxing an entity's income and gains.

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[1] This difference is a fairly modern one. Until the nineteenth century, "companies" were not taxable persons in their own right although tax could be collected from them on account of tax ultimately due by their members: see John F. Avery Jones: "Defining and Taxing Companies 1799 to 1965". Chapter 1. Studies in the History of Tax Law Volume 5. ed. John Tiley. Oxford, Hart Publishing 2012.

[2] It may still have liabilities to account for and collect tax on behalf of others e.g. operating the UK payroll withholding system known as PAYE ("Pay As You Earn") on the earnings of directors and employees.

[3] See 6.5.1 for a contrast between this idea of "tax transparency" and the concept of "tax translucency" which applies to French partnerships under French tax law.

Typically, "partnerships" are regarded under UK tax law as "tax transparent" in the sense described above. Hence it is essential to define a “partnership”. However, entities other than partnerships can be "tax transparent". In the UK, this is true of some trusts. This is discussed further in 4.2 and 4.3. It is also typically true of those contractual joint ventures and co-ownership arrangements which fall short of being "partnerships". Therefore, an arrangement or entity can be "tax transparent" without necessarily being a "partnership".

Even if an arrangement is "tax transparent", the precise mechanics for achieving this may vary. Suffice it to say at this stage that the rules differ between taxes. Hence "tax transparency" for income tax purposes differs from "tax transparency" for capital gains tax purposes. Moreover, and crucially, a "tax transparent" entity is rarely, if ever, a "nothing" for tax purposes. It is likely to have enduring significance when taxing those connected with it, even if the members of the entity are taxed as if they were directly interested in its underlying income and gains. The enduring structural significance of a “transparent” entity and its implications are discussed further in subsequent Chapters, not least in relation to whether certain corporate affiliation tests can be met by “tracing” ownership through a “transparent” entity.

In a globalised economy, questions of entity classification and tax transparency have become more common. In the UK, this has been especially true when UK taxpayers have claimed double taxation relief for non-UK income tax, when they invest in non-UK arrangements or entities. There has been major litigation twice in the last twenty-five years on whether UK investors in non-UK arrangements can treat them as "transparent" in order to claim a UK credit for non-UK tax on the underlying income from the arrangement. This litigation is discussed in Chapter 2.

When defining "tax transparency", one needs to take account of other rules which impute undistributed income and gain from a UK or non-UK entity or arrangement to a UK-taxable person. That person will have a relevant, defined connection with the arrangement e.g. a shareholder in a company or the settlor of a trust. These rules tend to be broadly-drafted anti-avoidance rules which limit deferral of UK tax on income and gains by accumulating them within the entity or arrangement. Good examples are the "controlled foreign company" rules[4]; the "transfer of assets abroad" rules[5]; and the income and capital gains tax "settlement" rules[6]. The effect of these rules is often similar to tax transparency but is not quite the same concept. Hence they are not discussed in detail in this thesis. In particular, such rules are structured so that income or gain of an entity or arrangement is not usually attributed to a person outside the UK tax charge so as to make it non-taxable[7]. To do so would defeat their anti-deferral purpose whereas such issues tend to be irrelevant when dealing with more classic examples of “tax transparency”. Such attribution rules are also asymmetrical: income

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[4] Part 9A Taxation (International and Other Provisions) Act 2010 (“TIOPA”).

[5] Part 13 Chapter 2 Income Tax Act 2007 (“ITA”).

[6] Part 5 Chapter 5 Income Tax (Trading and Other Income) Act 2005 (“ITTOIA”); and Sections 77 – 98A Taxation of Chargeable Gains Act 1992 (“TCGA”).

[7] See *Becker v Wright* 42 TC 591, a decision on an earlier version of the income tax “settlement” rules, but which is now reflected in Section 648(1) and (2) ITTOIA. UK-source income can be attributed under the income tax “settlement” rules to a non-UK-resident: see *IRC v Countess of Kenmare* 37 TC 383 and also HMRC Trusts Settlements and Estates Manual TSEM10310 (accessed 15 June 2020). As one commentator rightly points out, attribution of UK-source income from UK-resident trustees to a non-UK-resident settlor may reduce the UK tax charge: the charge on a non-UK-resident is often limited to (any) tax deducted (or treated as deducted) at source at 20% only: see Sections 810-828 ITA and Mark Brabazon: “International Taxation of Trust Income – Principles, Planning and Design”, Cambridge University Press 2019, at page 40. Hereafter “Brabazon.

and gain may be attributed to the relevant UK taxpayer but underlying losses of the entity or arrangement are almost never attributed in this way. By contrast, a taxpayer with a relevant interest in a partnership, some kinds of trust and most simple co-ownership arrangements should be taxed as if it owned a proportionate slice of the entity's underlying revenues and assets, and bore any losses accordingly. In short, there should be no asymmetry of the kind mentioned above, when dealing with more classic examples of "tax transparency"[8].

Questions

1.3 This thesis aims to shed light on an area of UK tax law which, while highly theoretical in some respects, has very important practical implications, especially in a globalised economy. Furthermore, this area has been relatively neglected by the UK legislature and courts.

With this aim in mind, the thesis addresses the following overarching question: How does the UK classify entities for tax purposes and, consequently, when and how does it regard an entity as being tax "transparent"? Is the UK's approach to entity classification satisfactory, especially taking into account its double taxation treaties and EU law? Is an alternative approach to be preferred?

In addressing the main question, the thesis considers a number of subsidiary questions:

(i) Why is it important to classify entities for UK tax purposes?
(ii) How does the UK do this, especially in relation to companies, partnerships and trusts?
(iii) What is the connection between classifying entities and "tax transparency"?
(iv) What does "tax transparency" mean in UK tax law? Does it have more than one meaning?
(v) How do UK double tax treaties address entity classification and tax transparency issues, especially when the UK and its treaty partners classify an entity in different ways?
(vi) Is the UK approach to entity classification affected by EU law?
(vii) Is the approach of other jurisdictions (in particular, the United States and the Netherlands) to these issues instructive?
(viii) What are the weaknesses in current UK thinking on "tax transparency" and entity classification? How can it be improved?

In addition to a concluding Chapter, the thesis has five substantive Chapters. The first considers the existing UK rules for defining taxable entities, other than trusts. In particular, it discusses the judicial decisions to date and the strengths and weaknesses of those rules. The second Chapter considers the existing UK rules for defining trusts and the extent to which they are "transparent" when taxing their income and gains in the UK. The third Chapter further explores what "transparency" means, and considers how this concept affects UK taxes which do not relate to income and gains (e.g. VAT, stamp duty). The fourth Chapter considers how effectively entity classification and tax transparency issues have been addressed in UK tax treaties, taking account in particular of OECD developments over the last twenty-five years. This Chapter also considers whether UK law and practice in this area is

[8] Some of the anti-deferral rules referred to above do not even impute underlying income as such but create a standalone "sui generis" UK tax charge whose quantum is measured by reference to elements of the underlying income of the entity. For example, this seems to be the case with the UK "controlled foreign company" rules: see *Bricom Holdings Ltd v IRC* [1997] STC 1179, a decision on the predecessor rules into Part 9A TIOPA.

compatible with EU law. The fifth substantive Chapter compares and contrasts the UK approach with that of the USA and the Netherlands. There are three supporting Appendices. The law is stated as at mid-July 2020.

The current UK approach to classifying entities and establishing whether they are "transparent"

2.1 The UK treats an individual as taxable on income and gains in his or her own right[9]. However, complications immediately emerge when identifying a "company" i.e. the type of entity subject to UK corporation tax on its income and gains so long as (i) it is not acting in a "fiduciary or representative" capacity[10]; and (ii) it is UK-resident or it is trading as a dealer in or developer of UK land or it is trading through a UK "permanent establishment"[11].

2.2 The key (and highly problematic) definition of a "company" for the purposes of the UK corporation tax charge is in Section 1121 Corporation Tax Act 2010 ("**CTA 2010**"), which is based on predecessor wording in Section 832 Income and Corporation Taxes Act 1988 ("**ICTA 1988**"). Section 1121 is an exhaustive definition. It reads:

> "(1) In the Corporation Tax Acts, 'company' means any body corporate or unincorporated association, but does not include a partnership, a co-ownership scheme (as defined by Section 235A of the Financial Services and Markets Act 2000), a local authority or a local authority association.
>
> (2) Subsection (1) needs to be read with Section 617 (under which the trustees of an authorised unit trust are treated for certain purposes as a UK resident company)."

2.3 The special UK tax treatment of an "authorised unit trust" (a trust-based form of regulated collective investment scheme) is discussed further at 4.3.6.2. Co-ownership schemes are another form of "tax transparent" collective investment vehicle. Both these entities are specialised, limited exceptions to the general rule in Section 1121. A "local authority" is a UK local government administrative unit and a "local authority association" is a formalised group of such bodies. They have no great significance for the purposes of this analysis. All these entities are specific exceptions to the general definition of "company" in Section 1121. This definition has three key elements: it includes a "body corporate" and an "unincorporated association" but excludes any entity which is a "partnership".

2.4 There is a similar definition of "company" for capital gains tax purposes in Section 288(1) TCGA. This by contrast is non-exhaustive. It reads as follows:

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[9] Although an individual can be taxable on income and gain differently, depending on the capacity in which that individual is acting: on his or her own account, as a trustee or as an executor or administrator of a deceased person's estate.
[10] Sections 3 and 6 Corporation Tax Act 2009 ("**CTA 2009**").
[11] Sections 5-5B CTA 2009.

"'Company includes any body corporate or unincorporated association but does not include a partnership, and shall be construed in accordance with Section 99".[12]

The next step is to analyse the three elements mentioned above. Before doing so, it should be added that the concept of an "entity" does appear in UK tax legislation. It is clearly not limited to a corporate body but is otherwise undefined. Furthermore, its use is fairly peripheral e.g. the definitions of "generally accepted accounting practice" in Section 997 ITA and Section 1127 CTA 2010, as well as the (now repealed) Section 340 TIOPA.

2.5 "Unincorporated association"

An "unincorporated association" is, for corporation tax purposes, usually regarded as a contractually-based (not trust-based) entity which, according to dicta in the Court of Appeal, lacks legal personality and which exists for non-business purposes. As Lawton LJ put it in the Court of Appeal in *Conservative and Unionist Central Office v Burrell*[13] :

> "I infer that by 'unincorporated association' in this context [i.e. the statutory predecessor of Section 1121(1) CTA 2010] Parliament meant two or more persons bound together for one or more common purposes, **not being business purposes**, [emphasis added] by mutual undertakings each having mutual duties and obligations, in an organisation which has rules which identify in whom control of it and its funds rests and on what terms and which can be joined or left at will. **The bond of union** between the members of an unincorporated association **has to be contractual** [emphasis added]."

A good example of such an organisation is that type of club which is not a separate legal person but an aggregation of members based on a contract; formed to provide its members with the benefits of club membership and simply aiming to cover costs by raising membership fees[14]. Of course, some clubs take the form of a "body corporate", a concept which is discussed further in 2.6.

"Unincorporated associations" are in practice rather rare beasts for tax purposes (and for corporation tax in particular). Historically, this was not always so. Until it became much easier in the mid-nineteenth century to incorporate a company by registration and the Bubble Act of 1720 was repealed, many so-called "companies" which did have business purposes were in fact unincorporated

[12] Section 99 treats a unit trust scheme as a company with issued share capital for capital gains tax purposes, although this is now subject to Section 103D TCGA: see 4.3.6.2.2. The definition in Section 288(1) applies "unless the context otherwise requires". An example of where the context does otherwise require is Section 170(9) TCGA. This defines a "company" more narrowly for the purposes of determining the make-up of a corporate group, when taxing chargeable gains. Section 170(1) is not considered in further detail but does include a "company" (other than a UK limited liability "partnership"), whether incorporated within or outside the UK.

[13] [1982] 2 All ER 1 at 4b

[14] In *Blackpool Marton Rotary Club v Martin* 62 TC 686, a rotary club argued that it was a partnership subject to income tax, and not an "unincorporated association" subject to corporation tax. Hoffmann J (as he then was) disagreed, stating: "The members of a club are not individually entitled to share in any profits which may arise from its activities. Their entitlement is to whatever privileges are conferred on them by the rules, and no more. Equally, they are under no liability to share in the losses of the club. Their liability is to pay the subscriptions and whatever other dues they may be responsible for under the rules, but nothing more. Those are vital distinctions between a partnership and a club…." These remarks are broadly consistent with the dicta of Lawton LJ in *Burrell.*

associations: in effect, a form of partnership with a large and fluctuating body of members and whose business property was held on trust for those members. Hence they were often referred to as "deed of settlement companies". The Joint Stock Companies Act 1844 prohibited the formation of new unincorporated bodies with more than 25 members (this was reduced to 20 from 1856)[15]. The 1844 Act did not, however, apply to existing bodies. From 1857, such "deed of settlement companies" with more than 20 members could carry on a trade or business. However, each member was severally liable for the debts of the organisation without a right of contribution from the other members. This incentivised such organisations to incorporate under the 1844 Act[16].

The UK tax authorities (Her Majesty's Revenue and Customs or "HMRC") do not agree with the statement of Lawton LJ cited above. While their view has yet to be retested in litigation, they regard Lawton LJ's statement as not strictly necessary for the decision in *Burrell*, which is correct. They also regard it as defining "unincorporated associations" too narrowly, not least because historically, "unincorporated associations" have existed for a business purposes. In their published guidance[17], they state that "[t]here is no reason why an unincorporated body should not have trading or business objects, or carry on significant commercial activities"[18]. In particular, the UK tax authorities regard some forms of joint venture which fall short of being a partnership as nevertheless being "unincorporated associations" for UK tax purposes. However, they clearly do not regard all such joint ventures as being "unincorporated associations" and it is very unclear where the dividing line falls[19].

Similar doubts have been raised about the dicta of Lawton LJ in the *Burrell* case in wider academic circles[20]. Harris explores the origins of the definition of "company" for corporation tax purposes which is now in Section 1121(1) CTA 2010. A number of formulations (including other entities in addition to "bodies corporate") had been used over the century prior to the 1965 introduction of corporation tax. Furthermore, in their (non-public) Notes on Amendments to Clauses in the 1965 Finance Bill, the then Inland Revenue (HMRC's predecessor) indicated that "unincorporated association" was intended to cover any "grouping [other than a partnership] of individuals in any form which has some

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[15] This provision of the 1844 Act eventually became Section 716(1) Companies Act 1985, which was finally repealed by the Regulatory Reform (Removal of 20 Member Limit in Partnerships, etc) Order 2002 SI 2002 No 3203. It had already ceased to apply to professional partnerships. For an example of an early form of unit trust which did not fall foul of this restriction on the number of members, see *Smith v Anderson* 15 ChD 247.

[16] For further discussion, see "John F. Avery Jones CBE: Defining and Taxing Companies 1799 to 1965" in J. Tiley ed. "Studies in the History of Tax Law" op. cit. 28; and paragraphs 1-3 of Gower: Principles of Modern Company Law (10th edition - 2016).

[17] Company Taxation Manual CTM41305 www.gov.uk/hmrc-internal-manuals/company-taxation-manual/ctm41305 (accessed 15 May 2020). For similar views expressed in a purely personal capacity, see Victor Baker: "Conservative and Unionist Central Office v Burrell (1981) A Case of Hidden Significance" Chapter 12, "Landmark Cases in Revenue Law" ed: John Snape and Dominic de Cogan. Hart Publishing 2019, at page 267.

[18] Nor do they think that the tie between the members of such an association need amount to a legally enforceable contract. However, they consider that there must be an organisation of persons with an identifiable membership bound together for a common purpose by identifiable rules; and the organisation must be distinct from those persons who would be regarded as its members. That organisation must not be some other form of association recognised in law e.g. a body corporate or a partnership. Nor will it include trustees whose duties are fiduciary and who in any case are not subject to corporation tax on profits accruing in a fiduciary capacity: see Section 6(1) CTA 2009.

[19] See Part F of Victor Baker op. cit.

[20] See Peter Harris: "Company, Person, Body of Persons, Entity: What's the Difference and Why?" [2011] BTR 188 and especially at pages 203-8 (hereafter "Harris").

recognisable existence for tax purposes apart from its individual members". Or, to quote Harris, "the broadest possible range of 'bodies' from political to religious to educational to commercial"[21].

In the author's view, this expansive reading of "unincorporated association" (with the related uncertainties regarding its scope) is exactly what Lawton LJ was seeking to avoid when deciding what bodies pay corporation tax, even though his formulation undoubtedly jarred with the broader earlier idea of an "unincorporated association"[22]. In essence, Lawton LJ was saying that, for corporation tax liability purposes, unincorporated arrangements for business purposes should either be regarded as partnerships (and hence outside corporation tax altogether but taxable at partner level) or, if they were not partnerships, subject to direct taxation only at the level of the participants themselves. In particular, such arrangements (e.g. co-ownership of commercial property or other joint ventures falling short of partnership) should not be separate taxable entities (i.e. "companies") for corporation tax purposes.

This is in fact a highly practical approach (although - see 7.2.2 - very different from the approach taken for US Federal income tax). Otherwise a contractual joint venture falling short of partnership could well be subject to corporation tax as an "opaque" entity. This would have very unwelcome consequences for parties who have, for example, entered into a non-partnership business venture where they share certain costs but not profits.

A set of barristers' chambers is a good example of such a joint venture. Each member of chambers only shares chambers costs (e.g. rent) but otherwise operates as a sole trader and would expect to be taxed as such on his/her profits as they arise. Similarly, a member of chambers would expect to claim relief for any losses from practising as a sole trader, especially in the early years. This would be the expected and long-established tax outcome even though there is a formal legal business relationship between members of chambers. Moreover, each typically has a recognisable, and often prestigious, brand distinct from its individual members from time to time.

Treating such an arrangement as an "unincorporated association" for tax purposes entails two levels of taxation (corporation tax at entity level and then income tax at member level on a subsequent profit distribution)[23]. This would not reflect the underlying commercial reality and expectation of the participants, who are only a fairly loosely integrated group of sole traders. It could also be a worse tax outcome than in a full partnership where the partners alone (and not the partnership entity) are directly taxed on their shares of partnership income and gains; and can claim relief in respect of underlying partnership losses. Lawton LJ's formulation preserves broad parity in this respect between partnerships and unincorporated commercial joint ventures falling short of partnership. In effect, he

[21] To some extent, as Harris indicates, Inland Revenue thinking may have been inspired by the short-lived 1952-3 Excess Profits Levy. This covered "unincorporated societies", a concept believed to include, in particular, unincorporated building societies; and trustees carrying on a business (other than for individual beneficiaries).
[22] As is noted in Part H of Victor Baker op. cit., there are other non-tax contexts in which modern UK statutes indicate that an unincorporated association can carry on a trade or business, with or without a view to profit: see Section 1161 Companies Act 2006. This no doubt reflects thinking inherited from early nineteenth century company law and the era of "deed of settlement" companies. Similarly, Section 1173(1) Companies Act 2006 appears to treat a partnership as one particular form of unincorporated association. This is not of course the approach of Section 1121(1) CTA 2010.
[23] Since the abolition of dividend "tax credits" from April 2016, there is little scope for a UK-resident individual member of a "company" to obtain relief for entity level corporation tax when computing its income tax liability on profits distributed to that individual.

treats both arrangements as taxable only at the level of their members. Furthermore, his formulation avoids losses of such a joint venture becoming trapped within it and unusable by its members. Trapped losses would result if that venture were subject to corporation tax as a "company"[24], on the basis that it was an "unincorporated association"[25].

The HMRC interpretation of "unincorporated association" makes more sense in other contexts where the question at issue is not what entities are subject to corporation tax. In particular, the tax legislation contains other references to an "unincorporated association" in contexts far removed from whether an entity is liable to corporation tax. For example, Chapter 8 Part 2 Income Tax (Earnings and Pensions) Act 2003 ("**ITEPA 2003**") sets out situations in which workers who are made available to clients by "intermediaries" can be taxed as employees, even if they would not be regarded as employees on general legal principles. The result is that the "intermediary" can be required to operate PAYE, as well as accounting for UK National Insurance (i.e. social security) contributions.

Section 51 ITEPA 2003 makes clear that a "company" can be an "intermediary" for these purposes. Section 61(1) defines a "company" exhaustively as "a body corporate or unincorporated association, and does not include a partnership [which is treated as an "intermediary" separately under Section 52 ITEPA 2003]". On the face of it, the definition of a "company" in Section 61(1) closely resembles Section 1121(1) CTA 2010. Yet in relation to Chapter 8 Part 2 ITEPA 2003, there is no reason not to treat as an "unincorporated association" a commercial joint venture which falls short of partnership. This avoids creating a major loophole in the definition of "intermediary".

There are even places in the corporation tax legislation where it may be appropriate to apply something akin to HMRC's broader interpretation of "unincorporated association". These again involve cases where the key question is not what entities are subject to corporation tax. A good example is the definition, for corporation tax purposes, of when persons are "connected", in Sections 1122 and 1123 CTA 2010. This definition turns in part on the meaning of "company". Section 1123(1) separately defines "company" for the purposes of Sections 1122-3[26]. In particular, it states that "'company' **includes** [emphasis added] any body corporate or unincorporated association, but does not include a partnership [partnerships being dealt with elsewhere in Sections 1122-3]". Therefore, the definition of "company" for the purposes of Sections 1122-3 is not exhaustive, unlike Section 1121(1), which uses the word "means", not "includes". Consequently, there is scope to treat an

[24] Even if the members of the unincorporated joint venture were themselves corporation tax payers, "consortium relief" would not enable them to access the losses of the venture if the latter were taxable as a "company". In particular that "company" would lack "ordinary share capital" and therefore would not be a "company owned by a consortium": see Section 153 CTA 2010.

[25] Since *Burrell,* there have been major changes to the corporation tax computation rules (e.g. the loan relationship, derivative contract and intangible fixed asset rules in Parts 5-8 CTA 2009). Hence the bases for computing taxable profit for income tax and corporation tax have diverged greatly since 1982. Therefore the interpretation of "unincorporated association" favoured by HMRC would mean that a very different basis of tax computation would apply to a partnership of individuals, compared to an unincorporated commercial joint venture between individuals which fell short of being a partnership. This divergence is hard to justify because the two situations may in reality be very similar. Lawton LJ's restrictive definition of "unincorporated association" largely sidesteps this difficulty.

[26] Implicitly displacing Section 1121(1).

unincorporated commercial joint venture falling short of partnership as being a "company" (if not an "unincorporated association"), when determining whether persons are "connected"[27].

Lawton LJ in *Burrell* was focussing directly on whether the Conservative Party was a "company" subject to corporation tax on its investment income. The somewhat rough-and –ready line he drew leads to a sensible outcome. However, in other contexts in which the tax legislation uses the term "unincorporated association", a broader meaning[28] than that proposed by him may well be appropriate[29].

2.6 A "body corporate"

2.6.1 A "body corporate" is a separate legal person clearly distinct from its members (if any) which is capable of acquiring rights and incurring obligations and which typically comes into being because of a publicised state-sanctioned act of creation. Incorporation by registration under company formation legislation (e.g. the UK Companies Act 2006) is the most common method of such creation. However, it is far from unique. For example, many such legal persons have been incorporated in the UK by Royal Charter or private act of parliament e.g. the East India Company as well as canal and railway companies in the eighteenth and nineteenth centuries. [30]

For these purposes, an "act of creation" must be a legally-recognised and publicised step by a government-sanctioned body whereby a new legal person is brought into being and notified to third parties as such. A simple contract between the members of a legal person is not enough, even if that may be a necessary precondition before the act of creation can occur. Hence under modern UK company registration procedure, the founding member or members of a company must submit a signed memorandum and articles of association to the Registrar of Companies. However, the new legal person only comes into being when the Registrar accepts those documents and formally admits the company to the public Register of Companies.

For UK corporate and tax purposes, a "body corporate" need not always have more than one member. For example, in UK company law, a single shareholder suffices for a private limited company. A "body corporate" need not have a business purpose: many UK charities take the form of UK private companies limited by guarantee and a number of non-profit-making clubs are structured as "bodies corporate". The example of a company limited by guarantee shows that members' interests in a body corporate do not necessarily take the form of transferable shares representing paid-in capital (although of course they often do). Lastly, for UK corporate and tax purposes,

[27] In this respect, the definition of "connected persons" for income tax purposes is identical: see Sections 993-4 ITA, and in particular Section 994(1).

[28] More in line with Inland Revenue thinking at the time of the Finance Bill 1965.

[29] In such other contexts, the legislation has in some cases moved away altogether from the "unincorporated association" concept, which helps avoid confusion. A good example is the definition of "securities" in ITEPA 2003 for the purposes of taxing employment-related securities. The first limb of that definition, in Section 420(1)(a), refers to "shares in any body corporate (wherever incorporated) or in in any unincorporated body [emphasis added] constituted under the law of a country or territory outside the United Kingdom".

[30] There are also strong arguments (see Gerald F. Montagu: "Is a Foreign State a Body Corporate?" [2001] British Tax Review 421) that a non-UK state is a form of "body corporate", although in such cases it may not always be possible to identify a clear publicised act of creation e.g. when a new state (e.g. the USSR) emerges from the chaos of revolution and civil war. Not that that is fatal because the same probably applies to corporations created by English common law such as the Crown or "corporations sole" such as a bishopric.

membership of a "body corporate" need not carry with it limited liability (although of course limited liability is commonplace). Specifically, UK company law expressly permits the incorporation of a private unlimited company[31]. Its members (of whom there must be at least two) have potentially unlimited liability to make good any excess of liabilities over assets if the company goes into liquidation. However, the members are not directly liable to the company's creditors. Even if they must make good any shortfall, the company's obligations are its alone. This is consistent with it being an entirely separate legal person from its members (unlike, for example, a Scottish partnership which is also a separate legal person, but whose partners can be sued as guarantors of the partnership's obligations by partnership creditors, as discussed further in 2.10.3 and 2.10.4 below).

2.6.2 The UK courts can be expected to treat as a "body corporate", and hence a "company", for UK taxation purposes any legal person brought into being by an official publicised step under the law of one of the constituent parts of the United Kingdom or another jurisdiction, so long as the underlying law indicates expressly or by necessary implication that the new legal entity, as well as being a separate legal person, is also a "body corporate" whose identity, assets, liabilities and activities are clearly distinct from those of its members (if any). This will not always be the case. In the words of one recent commentator, "Incorporation has an ancient heritage and remains a difficult and diffuse concept that is not congruent with 'legal personality'"[32]. It will be necessary to look at the rules bringing the separate legal person into being to decide if it is to be elevated to the status of a "body corporate" or, as one judge put it, there is a "manifest intention to incorporate"[33]. In *Maclaine Watson & Co Ltd v Department of Trade and Industry and related appeals*[34], the House of Lords ruled that the UK had by statutory instrument treated the International Tin Council as a separate legal person with the legal capacities of a body corporate without it actually being a UK domestic body corporate. As Lord Oliver, giving the main judgment, put it, at page 547:

> ".....the effect of the grant of the legal capacities of a body corporate was that in United Kingdom law the [International Tin Council], though not formally incorporated, was invested with a legal personality distinct from its members…."

He went on to point out that there were good reasons for conferring separate legal personality without creating a UK domestic corporation. In particular, the members of the International Tin Council were sovereign states which would be reluctant to submit the internal workings of the entity to the domestic jurisdiction of one of the member states and to subject the entity to a domestic winding-up jurisdiction[35].

[31] Section 3(4) Companies Act 2006. An unlimited liability company can be either a company with share capital or a company whose members do not hold share capital but provide a guarantee to the company instead.
[32] See Victor Baker op. cit. at page 287.
[33] Atkin LJ in *Mackenzie-Kennedy v Air Council* [1927] 2 KB 517 at 534, citing Littledale J in *Conservators of the River Tone v Ash* (1829) 10 B&C 349. On the facts Atkin LJ found out that there was no such intention.
[34] [1989] 3 All ER 523
[35] For further discussion of the *Maclaine Watson* decision, see the decision of the House of Lords in *Arab Monetary Fund v Hashim and others (No 3)* [1991] 1 All ER 871. For an earlier and more domestic example of a court recognising the existence of a separate legal person with "an existence apart from its members", which was nevertheless not a "body corporate", see the decision of the majority of the House of Lords in *Bonsor v Musicians' Union* [1955] 3 All ER 518. This case related to a registered trade union which was being sued by a former member for damages for wrongful expulsion.

It has also been argued that a "body corporate" must have "perpetual succession" i.e. prior to it being wound up, its membership can change without affecting its continued existence, rights and liabilities[36]. As discussed in 2.9.7 below, it is not clear that "perpetual succession", as so defined, is confined to entities which are "bodies corporate".

2.7 *UK LLPs and EEIGs*

On occasion, an entity which is a "body corporate" will nevertheless be excluded from chargeability to UK corporation tax, whatever its territorial connections with the UK. In particular, the Limited Liability Partnerships Act 2000 sets out the procedure for creating, and the structure of the entity known as a "UK LLP". The 2000 Act explicitly describes the UK LLP as a "body corporate". This is to maximise the chances of members' limited liability being respected in non-UK jurisdictions. However, Section 863 ITTOIA, Section 1273 CTA 2009 and Section 59A TCGA explicitly treat a UK LLP as a "partnership" where it carries on a trade, profession or business "with a view to profit". Therefore, its income and capital gains are taxed in the hands of its members, rather than the UK LLP itself, and those members are typically treated as partners in a partnership rather than mere members or employees of a body corporate[37]. In effect, a UK LLP is, unusually, a form of company typically taxed on a "lookthrough" basis for UK tax purposes, very much along the same lines as a partnership. A rough analogy is the so-called S corporation in the US which is further discussed in 7.2.4.1, although the S corporation regime is triggered by a formal taxpayer election, whereas the "lookthrough" treatment of a UK LLP is more or less automatic. Furthermore, the "lookthrough" taxation regime applying to a S corporation is not identical to the "lookthrough" regime applying to a partnership for US tax purposes[38].

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[36] See *The Conservators of the River Tone v Ash* (1829) 10 B&C 349, cited by Atkin LJ in *Mackenzie-Kennedy v Air Council* [1927] 2 KB 517. Neither of these cases discusses "perpetual succession" in detail. See also Gerald F. Montagu *op cit.* where the author's "fundamental use" test for whether an entity is a "body corporate" requires that the entity have "perpetual succession".

[37] The UK LLP is not to be treated as a partnership for certain other tax purposes e.g. VAT, stamp duty and stamp duty reserve tax. There are special transparency rules for partnerships (including UK LLPs) in relation to Stamp Duty Land Tax: see in particular Schedule 15 Finance Act 2003 which is discussed at 5.7.2 to 5.7.7. Where a UK LLP ceases to carry on a trade, profession or business "with a view to profit", it continues to be taxed as a partnership if the cessation is only temporary or during a winding-up following a permanent cessation if the latter is not taking place for tax avoidance reasons and the winding-up period is not "unreasonably prolonged". If a liquidator of the UK LLP is appointed or the court makes a winding-up order (or non-UK equivalent), then the LLP will cease to be taxed as a partnership. The extent of the transparency required in respect of UK LLPs by Section 863 ITTOIA was considered by the First-Tier Tribunal in *Bayonet Ventures LLP and another v HMRC* [2018] UKFTT 262 (TC). In that case, the judge (following the Court of Appeal in *Peter Vaines v HMRC* [2018] STC 297) said that Section 863 does not disregard the LLP altogether and treat all its activities as carried on directly by its members, whether or not jointly and severally. It simply assimilates the position of LLP members to that of partners in a non-LLP partnership. Recently, the Upper Tribunal (Tax and Chancery Chamber) ruled that Section 863(2) also treats a UK LLP as a partnership, and not a company, for the purposes of the return filing, tax enquiry and appeal procedures in TMA. Those procedures should be followed even if the eventual result of the enquiry and any appeal is that the LLP is not carrying on a business, etc "with a view to profit" so that it should be taxed as a company, not a partnership: see *HMRC v Inverclyde Property Renovation LLP and Clackmannanshire Regeneration LLP* [2020] UKUT 161 (TCC). For restrictions on using losses of a LLP and on the reliefs available to pension funds investing in a "property investment LLP", see John Snape: "Corporate Income Tax Subjects in the United Kingdom" in Chapter 33, "Corporate Income Tax Subjects" ed. Daniel Gutmann. Volume 12, EATLP International Tax Series. IBFD (2013).

[38] The UK Office of Tax Simplification ("OTS") has considered the idea of introducing, for UK tax purposes, a "lookthrough" taxation regime for small companies similar to the S corporation rules. In its Final Report of

Another older example of a body corporate being carved out of the UK corporation tax regime is the European Economic Interest Grouping ("EEIG"). EEIGs are an EU legal conception, being largely modelled on the French "groupement d'interet economique" (which HMRC apparently regard as being "transparent" anyway for UK tax purposes, according to the list mentioned in 2.14.3). EEIGs are created pursuant to Council Regulation (EEC) No 2137/85 (hereafter "**the 1985 Regulation**") which has direct effect in Member States. In the UK, that Regulation is supplemented procedurally by the European Economic interest Grouping Regulations 1989 SI 1989/638 (as amended) (hereafter "**the 1989 Regulations**"). EEIGs are permitted to engage in certain ancillary economic activities e.g. research. In particular, Article 3(1) of the 1985 Regulation states that the purpose of a EEIG is to facilitate or develop the economic activities of its members and to improve or increase the results of those activities. Its purpose (unlike a UK LLP) must not be to make profits for itself, although its activities may still generate profit from time to time.

EEIGs are formed by their members entering into a contract which is then registered (in the UK with the Registrar of Companies): Articles 1(1) and 6. There must be at least two members from different EU/European Economic Area Member States. Article 1(2) confers full legal capacity on a EEIG but Article 1(3) provides that each Member State has a choice whether to regard a EEIG as having legal personality. To a UK lawyer, this is a strange distinction because one would regard legal personality as the inevitable result of the EEIG having full legal capacity. However, this is not the case in some civil law jurisdictions (notably Germany) where the fact that the EEIG members are liable for the entity's debts means that the entity itself cannot have full legal personality in that jurisdiction, even though it has full legal capacity[39].

In some but not all Member States, EEIGs are not just legal persons but in fact are formed as bodies corporate. The UK is one of these: see Regulation 3 of the 1989 Regulations. EEIG members have unlimited joint and several liability for the debts of the EEIG (Article 24 of the 1985 Regulation), like Scottish partners (although the latter are, strictly speaking, secondarily liable after the partnership). An EEIG member's liability can extend to debts taken on by the EEIG before a person became a member.

Article 40 of the 1985 Regulation states simply that "the profit or losses resulting from the activities of a grouping shall be taxable only in the hands of its members". In other words, it must be treated as "transparent" for the purposes of taxing its income and gains and allowing relief for any losses, although not for the purposes of other taxes (notably VAT and PAYE). Article 40 gives no further detail of how direct tax "transparency" is to be achieved. In particular, can any UK "permanent establishment" of a EEIG formed outside the UK be treated as that of the EEIG members so as to

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November 2016, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/564577/Lookthrough_paper_-_final.pdf (accessed October 2018), it decided not to recommend such a change, because it would make the current tax system more complex. In particular, to avoid such a regime imposing income tax (at higher rates) on companies which fund investment from retained after-tax profit, a "lookthrough" regime would need to be optional. That in turn would require taxpayers to obtain advice about whether to elect for such treatment. Moreover, those electing would only do so to save tax. The need for a separate "lookthrough" regime for UK companies is in any case not easy to justify, because a UK LLP is a body corporate which is generally taxed as a partnership anyway.

[39] For further detail, see John F. Avery Jones and others "Characterisation of Other States' Partnerships for Income Tax" (hereafter **"Avery Jones: Partnerships"**) [2002] BTR 375 at 393-4.

subject them to UK tax without full treaty protection? Moreover, Article 40 says nothing about the tax treatment of members if they assign their interests, as they can do under Article 22. Is such an assignment to be treated as a part-disposal of underlying EEIG assets or is the EEIG interest to be treated as a separate asset (and if so, what kind of asset)?

UK legislation further develops the transparency provided for in Article 40 of the 1985 Regulation. Sections 842 ITA 2007, 990 CTA 2010 and 285A TCGA all ensure that, for UK direct tax purposes, income and gain of a EEIG, wherever formed, is taxed at the level of the EEIG members and not at EEIG level. To achieve this, the EEIG is treated as the agent of its members or, if it carries on a trade or profession, as a partnership.

Section 285A(1) Rule 5 TCGA 1992 also treats the interests of EEIG members as being shares in the underlying EEIG assets, rather than as a separate asset. Those shares are usually determined by reference to a member's share of any EEIG profits under the contract which sets up the EEIG. This appears to go beyond what Article 40 strictly prescribes. It may suit a taxpayer to argue that an EEIG interest should in fact be treated as a separate asset from the underlying EEIG assets, despite the UK legislation. However, the courts may well not be receptive: the preamble of the 1985 Regulation states that while profits or losses from the activities of the EEIG should be taxable only in the hands of its members, "it is understood that otherwise national laws apply, [emphasis added] particularly as regards the apportionment of profits, tax procedures and any obligations imposed by national tax law". This implies that each Member State has discretion when working out precisely how to give effect to Article 40[40].

2.8 Despite the exceptions in 2.7, it seems clear that for UK corporation tax purposes, the following types of company formed by registration under the UK Companies Act 2006 will in all cases be "bodies corporate" within Section 1121 CTA 2010: private companies limited by shares or guarantee; private unlimited companies; and public companies limited by shares (there being no scope for a public company to be limited by guarantee or unlimited). There is no scope for such entities to elect out of corporation tax.

Of course this leaves the much harder question of which non-UK entities will be "companies" within Section 1121 CTA 2010. It also leaves the related question of what entities are "partnerships", and hence are not "companies", for Section 1121 purposes.

2.9 "Partnership"

2.9.1 A key question remains what constitutes a "partnership" because Section 1121 CTA 2010 excludes a "partnership" from the definition of a "company", as does Section 288(1) TCGA 1992[41].

[40] Section 285A TCGA is, if anything, a clearer "lookthrough" rule than the normal capital gains tax "lookthrough" rule applying to partnerships under Section 59 TCGA. For fuller discussions of the UK tax treatment of a EEIG, see C.J. Wales, "European Economic Interest Groupings: Finance Act 1990" [1990] BTR 335; and Tarlochan Lall: "Taxation and the European Economic Interest Grouping" [1993] BTR 134. There have been significant changes in the relevant UK tax law since both these articles were written but they are still useful analyses.

[41] This exclusion can be read as indicating that, absent the exclusion, certain types of "body corporate" or "unincorporated association" can be "partnerships". The authors of Avery Jones: Partnerships op. cit. at page 394 fn 79 believe that the carve-out was to counteract the default classification of Scottish partnerships as

The classic English law definition of a partnership is in Section 1(1) Partnership Act 1890 ("**the 1890 Act**"). This defines partnership as the relationship between persons (plural) carrying on "a business in common with a view of profit". The 1890 Act applies to the entire United Kingdom and it consolidated much (but not all) of the existing common law of partnership at the time it was enacted.

This 1890 Act definition seems to have consistently informed (and indeed over-informed) judicial thinking on the meaning of a "partnership" for tax purposes, especially when considering whether non-UK entities are partnerships.

Because a partnership is a collaboration "with a view of profit", "partnership" and "unincorporated association" are usually mutually exclusive in English law (at least if one accepts the thinking of Lawton LJ: see 2.5). Furthermore, there can be no overlap between a "partnership" and a "body corporate" if (as is quite possible) the latter has only one member: Section 1 1890 Act requires at least two members of a partnership. In any case, Section 1(2) states (again, presumably to avoid any residual doubt) that the relation between the members of a UK-incorporated company is not a partnership. Equally, if a "body corporate" exists to pursue non-profit-making activity, it cannot be a "partnership" as so defined.

This leaves the question of what distinguishes a "body corporate" from a "partnership" if the relevant entity (which may be non-UK) has at least two members and pursues profit-making activity.

2.9.2 The answer to this question has become harder because the substantive difference between a "body corporate" and a "partnership" has become much narrower. Many modern "partnerships", especially in professional and financial services, are hard to distinguish from private limited companies in the way they are structured and run. A number of specific comments can be made.

2.9.3 *Limited liability*

"companies". However, Scottish partnerships have not generally been regarded as "bodies corporate", notably for the purposes of Section 1173(1)(b) Companies Act 2006 and despite exceptions such as the Sheriff Court decision on the Trade Descriptions Act 1968 in *Douglas v Phoenix Motors* 1970 SLT (Sh. Ct.) 57 (Tayside): see Paul Sutton and Jane McCormick "Scottish Limited Partnerships" Tax Journal, Issue 916, 26. The view that Scottish partnerships are not "bodies corporate" was common ground recently in *Baillie Gifford & Co v HMRC* [2019] UKFTT 410 (TC), where HMRC in particular argued, at paragraph 64, that a Scottish partnership did not have all the attributes needed to be a "body corporate", for the purposes of the pre-Finance Act 2019 VAT grouping rules. According to Victor Baker, in "Conservative and Unionist Central Office v Burrell (1981))" op.cit. at page 276, the exclusion of partnerships from the otherwise wide-ranging definition of "company" in Section 1121 CTA 2010 was "to avoid doubt". He refers to the Finance Bill 1965 notes on what became Section 46(5) Finance Act 1965. This is the statutory ancestor of Section 1121. The author agrees with Victor Baker. In particular, as a general legal matter, the concept of a "partnership" is meant to be distinct from that of a "body corporate": not only does the latter have legal personality but its identity, assets, liabilities and activities are clearly distinct from those of its members in a way which is not the case in relation to a partnership, whether or not a legal person. Similarly, the author believes that Section 1(2) Partnership Act 1890 was included to avoid doubt, by stating that the members of a UK-incorporated company do not thereby form a partnership. If Section 1(2) meant anything more, then presumably non-UK-incorporated companies would be partnerships which was presumably not intended: see Peter Harris: "Corporate Tax Law: Structure, Policy and Practice" (Cambridge University Press – 2013) at page 30. The substantive distinction between a body corporate and a partnership is discussed further in 2.9.

Limited versus unlimited liability of an entity's members cannot be a conclusive differentiating factor. UK company law has long permitted the creation of private unlimited liability companies, which are clearly a "body corporate" for tax purposes. The indirect nature of the unlimited liability of a member of such a company has already been discussed at 2.6.1. Partners in a classic English or Scottish law general partnership have unlimited joint liability for partnership debts, which is owed directly to the creditors of the partnership. In the case of Scottish partners, their liability is as guarantors of the obligations of the partnership, which has legal personality. However, such unlimited liability partnerships are increasingly rare.

As already discussed, UK LLPs, despite their name, are in fact a form of body corporate and hence their members' limited liability is not directly relevant to that of partners in a true partnership. However, it has long been possible, under the Limited Partnerships Act 1907, for a new or pre-existing partnership to register itself as a limited partnership with the UK Registrar of Companies. If it does so, then liability is limited (with caveats) to the extent of partners' capital contributions, for those partners who do not participate in the management of the partnership[42]. There must be at least one general partner in such a limited partnership, with unlimited liability for partnership debts. The general partner manages the limited partnership and is often a purpose-formed, lowly-capitalised UK private limited company. The partners who have limited liability owe that liability directly to the creditors of the limited partnership, unlike the shareholders in an unlimited company.

Looking further afield, there are a number of non-UK entities styling themselves as "limited liability partnerships" which are treated by HMRC as partnerships for UK tax purposes. The liability of their members for the debts of the entity is generally limited to the member's capital contribution even if the member takes part in the entity's management[43].

US law firms operating in the UK are a good example of such limited liability partnerships. Unlike UK LLPs, these are not "bodies corporate" benefiting from a special UK tax status. Rather they are non-UK "limited liability partnerships" (typically formed in Delaware or New York) which usually have separate legal personality yet regard themselves as partnerships for UK tax purposes on general principles. This point of view is broadly accepted by HMRC. This is so despite Section 301(1) of the US Revised Uniform Partnership Act typically making each partner an agent of the partnership entity, rather than

[42] The 1907 Act was amended in 2017 to make it even easier to use a limited partnership as a vehicle for tax-transparent venture capital investment funds. It has been used extensively for this purpose since the 1980's. In particular, the revised 1907 Act now permits (see Section 8D) the designation of a limited partnership as a "private fund limited partnership" (or "PFLP") if the partnership agreement is in writing and the partnership is a "collective investment scheme" for regulatory purposes. The meaning of "collective investment scheme" is discussed in 4.6.1. A limited partner in a PFLP is not required to make a capital contribution, unlike a limited partner in a 1907 Act limited partnership which is not a PFLP. The liability of a PFLP limited partner is nevertheless limited by the partnership property available to the general partner(s) to meet the debts and obligations of the limited partnership. Section 4(3A) allows a limited partner in a PFLP to withdraw any capital contribution it makes from the limited partnership without compromising its limited liability. This option is not available to a limited partner in a non-PFLP, although an equivalent effect can be achieved if most of a limited partner's capital contribution takes (as it usually does) the form of a loan. For PFLPs, a new Section 6A contains a non-exhaustive list of specific activities which a limited partner may undertake without being regarded as taking part in firm management and thereby compromising its limited liability. This list of permitted activities part-clarifies a grey area in limited partnership law.

[43] This limitation does not necessarily apply if there is a direct default of the member e.g. liability on its part to a third party for negligence.

of each of the other partners (as is the case in an English law partnership – which lacks legal personality - and, possibly, a Scottish law partnership)[44].

Hence the limited liability of partners in a partnership is now well-established, even if such partners take part in partnership management.

2.9.4. *Transferability of interests*

The free transferability of membership interests cannot be an entirely conclusive difference between a "body corporate" and a "partnership". It is true that, without the consent of the other partners, a partnership interest typically cannot be transferred so as to confer full partner status on the transferee. Absent such consent, the transferee has at most the right to the economic fruits of the partnership interest and must accept the account of profits agreed to by the partners. It has no right to vote as a partner or to take part in firm management or to inspect the partnership books[45].

However, the articles of association of private companies typically place very severe restrictions indeed on the transferability of members' interests. These restrictions are typically enforceable by the directors of the company. They are often reinforced with further restrictions directly enforceable among the members themselves and set out in a confidential shareholders' agreement. All these private company transfer restrictions are likely to be at least as strict as those applying to interests in partnerships. They may well prevent a transfer of even the economic benefits of a shareholding.

While a partner may be unable unilaterally to transfer the right to full partnership status to a purported transferee of its interest, the would-be transferor remains a full partner with rights as such e.g. to vote on management issues. In a private company, the would-be transferor of a company share can be in no better position than the proposed transferee, because its shares only entitle it to an ownership interest in the company but not to take part in management. However, this difference has nothing to do with the transferability of its interest. Rather it reflects the formal split between ownership and management which is a more obvious feature of a "body corporate" than of a partnership, even though most partners in large modern partnerships have little real say in management matters.

2.9.5. *Legal personality and members' entitlement to profits*

Legal personality is not necessarily a key difference between a "body corporate" and a "partnership". A "body corporate" is of course by definition a legal person, and moreover a legal person distinct from its members, with full capacity to acquire rights and incur obligations on its own behalf, thanks to its incorporation. A UK LLP is simply a type of "body corporate", with a special tax status.

By contrast, an English law partnership is an aggregate rather than an entity: it has no legal personality distinct from that of the partners. This lack of legal personality does not mean that the

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[44] See paragraph 6.10, and the corresponding footnote 8, of the 2003 Joint Report on Partnership Law of the English and Scottish Law Commissions (Law Com 283; Scottish Law Com 192) (hereafter "the Law Commission").www.scotlawcom.gov.uk/publications/reports/2000-9.

[45] See Section 31 1890 Act. However, Section 6(5)(b) Limited Partnerships Act 1907 provides that "A limited partner may, with the consent of the general partners, assign his share in the partnership, and upon such an assignment the assignee shall become a limited partner with all the rights of the assignor [emphasis added]."

partnership is a “nothing”. In particular, English law recognises the concept of "partnership property"[46]. Such property (which is not always easy to identify in practice) is segregated from the personal property of the partners, even though the partnership is not a legal person. It must be held and applied exclusively for the purposes of the partnership and in accordance with the partnership agreement. English law’s “aggregate” approach to partnership applies whether or not the partnership is limited under the 1907 Act. An English law partnership is a contract under which each partner is both principal and agent for the other partners when acting in the usual course of partnership business[47]. Hence the partners carry on the required “business in common” together directly. Together they directly co-own the “partnership property” in the manner provided for in the partnership agreement and the 1890 Act (including the rules regarding “partnership property”).

By contrast, a Scottish partnership (limited or otherwise) does have separate legal personality per se even though it too is formed purely by contract[48]. Section 4(2) of the 1890 Act clearly indicates that a Scottish partnership is typically regarded as a "partnership" for the purposes of that Act[49].

The nature of a Scottish partnership has been explored in tax litigation. *Major v Brodie*[50] is discussed in detail below. Scottish partnerships were further explored in *Memec* (see 2.13) and *Anson* (see 2.15). Their legal personality probably does not give rise to “perpetual succession”[51], although it is sufficient to enable the Scottish firm to be the debtor or creditor (but probably not the employer) of one of its partners. It also appears that the partners together with the Scottish firm carry on the required "business in common", although there is debate (see 2.9.6) whether the partners do so purely as agents of the partnership entity (the view of the Law Commission) or as both such agents and as principals in their own right. Scottish partners are concurrently liable, jointly and severally, with the partnership itself, for partnership debts (effectively acting as guarantors). The Scottish partnership is not a nominee or trustee for the partners. Hence it can own partnership property and so there is less need in Scots law for the “partnership property” concept because partnership assets are not commingled with the personal assets of a partner. Overall, the legal personality of a Scottish firm is a less absolute form of legal personality[52] than that present in a "body corporate". The latter is

[46] As defined in Section 20 of the 1890 Act.
[47] Section 5 of the 1890 Act.
[48] See dicta of Lord President Cooper giving the leading judgment in *Mair v Wood* 1948 SC 83.
[49] Section 1216(1) Companies Act 2006 also seems comfortable, by implication, that partnerships (Scottish or otherwise) can have legal personality. It reads “This section applies where a partnership constituted under the law of (a) England and Wales, (b) Northern Ireland, or (c) any other country or territory in which a partnership is not a legal person [emphasis added] is…..appointed as statutory auditor of an audited person”
[50] [1998] STC 491
[51] Paragraph 2.8 of the Law Commission op. cit. states that “There is serious doubt as to whether the legal personality of a Scottish partnership can continue on a change in the composition of the partnership”. No conclusive answer has been reached about whether a partner can nevertheless be the employee of a Scottish partnership, given its separate legal personality: see *Allison v Allison’s Trustees* (1904) 6 F 496 and *Fife County Council v The Minister of National Insurance* 1947 SC 629. A member of an English partnership cannot be its employee, because such a partnership is not a legal person and the same person cannot be both employer and employee; and also because a partner is a “co-adventurer not an employee”: see Lord Carnwath in *Clyde & Co v Bates van Winkelhof* [2014] 1 WLR 2047 at paragraph 59.
[52] Similar issues appear to arise in Canada in relation to partnerships (“societes de personnes”) created under Quebec law. This differs from the law of the English-speaking provinces and is of course derived from pre-1789 French law. Views differ about whether such partnerships are fully-fledged legal persons or merely exhibit elements of juridical personality such as a “separate patrimony”: see Boidman and Kandev: “Foreign Entity

a distinct "legal person" entirely separate from its members from time to time. Hence it, not they, carries on its activities, acquires rights and incurs direct liabilities to creditors, even if it is an unlimited company. The members of a company have no interest in the assets of a company nor in its underlying profits as they arise. The same is apparently not the case with a Scottish partnership, although there is some debate about the degree of separateness which exists between the partnership entity (which is not a nominee or trustee) and the partners[53]. This is an important reminder that the concept of legal personality may contain different gradations of such personality. That exhibited by a Scottish partnership is not the same as the legal personality of a "body corporate" incorporated under Scottish law.

As Peter Gibson LJ said in the Court of Appeal in *Memec v IRC* [1998] STC 754 at page 765:

> "Even a Scottish partner has an (indirect) interest in the profits of the partnership as they accrue as well as in the assets of the partnership. In a real sense the profits and assets are the profits and assets of the partners, the firm, their collective alter ego[54], merely receiving those profits and holding those assets for the partners who are the firm. They are jointly and severally liable for the firm's debts".

In the Court of Appeal in *Anson v IRC* [2013] STC 557, Arden LJ (as she then was and also not a Scottish lawyer) stated:

> "It would be unusual but not impossible for an entity with a separate legal personality, such as a company, to be tax transparent for English law purposes. One example would be the Scottish partnership where the partnership is a separate legal entity and holds the assets of the business, but the partners have an [indirect] interest in the assets and carry on business in common: this has been held by this court [in *Memec*] to be tax transparent".

Peter Gibson LJ in particular refers to Scottish partners having an indirect interest in partnership profits "as they accrue". A member of a company has no such interest in company profits which belong to the company alone as they accrue. Instead it must await a company resolution to distribute, at which time the member acquires a right to a separate income stream: dividends.

This right of a member to underlying profits as they arise is, in this author's view, a key difference for UK tax purposes between a "body corporate" and a partnership, even where the latter has separate legal personality (as in Scotland). Put another way, a litmus test of a "business in common" within

Classification and the Meaning of 'Corporation'/'Societe' in the Income Tax Act" (2009) Canadian Tax Journal Vol. 57, No 4, 800 and especially at 894 and 902.

[53] The Law Commission note (in paragraph 2.25 of their final report op.cit.) that the separate personality of a Scottish partnership prevents any partner suing for damage to partnership property or having an insurable interest in such property. However, a partner joining a Scottish partnership is not liable for debts of the partnership before he joined the firm because (despite its separate personality) those debts are the debts of other partners: see Avery Jones: Partnerships op.cit. [2002] BTR 375 at 405.

[54] The "alter ego" comment in particular needs to be treated with caution. It is not the observation of a Scottish lawyer and should not be read as meaning that a Scottish partnership holds partnership assets on trust for the partners. In the Supreme Court in *Anson v HMRC* [2015] STC 1777, discussed at 2.15.5, Lord Reed (a distinguished Scottish judge) observed that a partner in a Scottish partnership has an incorporeal movable right (i.e. a partnership share) but no direct proprietary interest in partnership assets. This is consistent with the view noted in fn 53.

Section 1(1) of the 1890 Act is now the putative partners' right to profits as they arise[55], and not always the mutual agency of the partners, unlimited joint liability for partnership debts or a partner's proprietary interest in the assets of the partnership. This is also a more reliable criterion for determining whether entities formed outside the UK are "partnerships" for the purposes of Section 1121 CTA 2010. Section 1121's reference to a "partnership" is presumably not limited to UK entities and hence this concept should not be applied to non-UK entities in a manner which is unduly beholden to the peculiarities of English partnership law (under which partnerships are not legal persons but are contracts based on mutual agency). These points will be revisited in 2.15.

The previous paragraph should not be read as meaning that entitlement to profits as they arise is the only litmus test of whether an entity is a partnership. Especially in relation to English law-type partnerships conducting an active business, rather than investment limited partnerships, it may be possible to conclude that there is a "business in common" within Section 1(1) of the 1890 Act, and that a member is a partner even where that person only has an entitlement to a fixed sum regardless of the profits of the business.[56]

The separate legal personality of a Scottish partnership reflects the French civil law influence in Scottish law, in particular as it existed prior to the 1707 Act of Union[57]. In other jurisdictions (notably those influenced by civil law), entities regarded as partnerships often have legal personality (or at least, as in Germany, the full legal capacity consistent with what English law would regard as separate legal personality). As discussed later (see for example, 3.8), the legal personality of civil law partnerships is closely linked to the concept of agency in civil law jurisdictions. This differs from English and Scottish law, especially regarding the ability of an agent to bind an undisclosed principal.

[55] The 1890 Act codifies the existing law of partnership, which is not displaced by the 1890 Act unless inconsistent with it: see Section 46 of the 1890 Act. A number of pre-1890 cases suggest that a partnership is primarily defined by the right of members to share in profits: see *Holme v Hammond* (1872) LR 7 Ex 218 at 234; and *Pooley v Driver* (1877) 5 Ch 458 at 473-6. In *Holme v Hammond,* Martin B (at pp 228-9) and Cleasby B (at p 234) indicated that the entitlement to profits must be accompanied by a voluntary contribution to capital of the putative partnership (although not all partnerships in fact require capital). In *Pooley v Driver,* Sir George Jessel MR relied on the criterion of profit entitlement in concluding that a so-called profit-linked loan in fact created a relationship of "dormant and active partners" between the lender and the borrower (who was actively carrying on the business which was being funded). The lender was effectively a limited partner but the case of course predated the Limited Partnerships Act 1970. To somewhat similar effect was *Lindsay Woodward & Hiscox v IRC* 18 TC 43 at 58, although in that case the factual basis for concluding that there was a partnership, rather than a loan carrying a profit-linked return, was more marginal.

[56] See the Court of Appeal in *Tiffin v Lester Aldridge LLP* [2012] IRLR 391. This concerned Section 4(4) Limited Liability Partnerships Act 2000 and the employment rights of a "fixed share partner" in a law firm which was a UK LLP. The individual in fact had a share of profits. Rimer LJ, giving the sole reasoned judgment, nevertheless considered (at paragraphs 19-24) earlier authorities on the 1890 Act, all of which appear to have related to English law professional services general partnerships. He concluded that, while an entitlement to profits was a prerequisite of partner status prior to the 1890 Act (see the cases in the previous footnote), all that was needed after the 1890 Act was an overall aim to make a profit coupled with a "business in common" i.e. a business where each putative partner is the agent of the others for all acts done in the course of the business. In such cases, a person could be a partner even if only entitled to a fixed sum. While this decision greatly expands the universe of possible partnerships, it only seems to do so where the relevant partnership law follows the English law mutual agency model (e.g. Canada) and partners are not effectively excluded from acting as agents of the other partners (as would be normal in a limited partnership). In any case, for tax purposes, the importance of entitlement to profits as an identifier of partnership seems to live on: see the case mentioned in fn 14.

[57] In *Mair v Wood supra,* Lord President Cooper traced back to the seventeenth century the separate legal personality of a Scottish partnership.

Most partnerships formed under state law in the USA have separate legal personality (although, interestingly, Delaware offers some scope to opt out of this separate personality[58]). This legal personality reflects a conscious choice taken, in the US Revised Uniform Partnership legislation, to accentuate the "entity theory" of partnership, not least to avoid legal problems which could otherwise arise from membership changes creating a "new" partnership[59]. Therefore, in the US context, legal personality goes hand in hand (unlike Scottish law) with a form of perpetual succession for partnerships.

To summarise, the presence or absence of legal personality is not a key difference between a "body corporate" and a "partnership", but the quality of that separate personality may be highly relevant, especially if it affects whether members are entitled to the entity's profits as they arise. The Scottish partnership illustrates how partners can be entitled to profits as they arise even if the separate personality of the firm means that it, not the partners, beneficially owns the partnership's assets. Assets (a property law concept) and profits (an accounting concept) are two different things, as will be further discussed in relation to *Anson* in 2.15.

2.9.6 Major v Brodie

At this point, it is convenient to consider *Major v Brodie* [1998] STC 491. This was a successful taxpayer appeal in the English High Court against a decision by the UK tax authorities to deny two individuals an income tax deduction for interest paid by them on business loans. The two individuals were partners in a Scottish general partnership A. Partnership A then became a partner, with an unrelated individual, in another Scottish general partnership, B. It was agreed that the two Scottish partnerships were separate legal persons. Therefore, it was possible for A to be a partner in B. The key question was whether B was carrying on its business of farming alone (being a separate entity) or whether A was also carrying on that business because it was a partner of B. The UK tax authorities argued that only B was carrying on the farming business because of its separate entity status. Therefore, the tiered partnership structure meant that no relief was available because the interest was being paid by partners in partnership A, which was not doing any relevant farming.

The court rejected this argument and found for the taxpayer. Distinguished experts opined on Scottish partnership law and what the separate personality of a Scottish partnership entailed. The lowest court, the Special Commissioner of Income Tax, in particular preferred the testimony of the expert acting for the taxpayer (Professor Murray) and found that the business of partnership B was being carried on both by the partnership entity itself and, crucially, by its partners which of course included partnership A.

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[58] 6 Delaware Chapter 15-201(a) provides: "A partnership is a separate legal entity which is an entity distinct from its partners unless otherwise provided in a statement of partnership existence or a statement of qualification and in a partnership agreement." There seems to be no explicit facility to opt out of separate legal personality in the case of a Delaware limited partnership: see S. 17-201(b) Delaware Revised Uniform Limited Partnership Act, although the contrary is suggested at part 98.26.1 in James Kessler QC "Taxation of Non-Residents and Foreign Domiciliaries" 2019-20" 18th edition. One commentator has queried whether 15-201(a), if invoked, would in fact be effective to deny a Delaware general partnership legal personality: see Kimberly Blanchard: "The Tax Significance of Legal Personality: a US View". New York University School of Law, Spring 2015 Colloquium on Tax Policy and Public Finance at pages 51-2.

[59] See Gerald Montagu: "*Anson* and Entity Classification Revisited in Light of Brexit: can an LLC Constitute a 'Body Corporate'?" [2016] BTR 466 at 488-9.

When classifying entities for UK tax purposes, Scottish partnerships are an example of how, even under the laws of the United Kingdom, an entity with legal personality is not automatically a “body corporate”. However, Scottish partnerships are in a somewhat different position to putative "partnerships" with separate legal personality formed outside the UK. In particular, the 1890 Act clearly applies to the entire UK and makes clear that the concept of partnership in that Act applies to partnerships formed under Scottish law[60]. Section 1(1) of the 1890 Act of course defines partnership as "the relation which subsists between persons carrying on a business in common with a view of profit".

Section 4 then provides:

> "(1) Persons who have entered into partnership with one another are for the purposes of this Act called collectively a firm, and the name under which their business is carried on is called the firm-name.
> (2) **In Scotland a firm is a legal person distinct from the partners of whom it is composed** [emphasis added]".

Section 5 provides:

> "Every partner is **an agent of the firm and his other partners** [emphasis added] for the purpose of the business of the partnership; and the acts of every partner who does any act for carrying on in the usual way business of the kind carried on by the firm of which he is a member bind the firm and his partners....."

Section 46 finally provides:

> "The rules of equity and of common law applicable to partnership shall continue in force except so far as they are inconsistent with the express provisions of this Act".

All of these rules apart from Section 4(2) are meant to apply across the UK. The court in *Major v Brodie* was mindful of that. It was also keen to ensure that the tax rules on interest relief should be applied to produce a uniform outcome as between England and Wales on the one hand, and Scotland on the other, despite differences in partnership law and in particular the separate legal personality of a Scottish partnership. This approach reflects the earlier decision of the House of Lords in *R v General Commissioners of Income Tax for the City of London, ex parte Gibbs*[61]. That was a decision regarding rules (now superseded) on computing English partnership profits in a taxable period where the makeup of the partnership changed. Three judges in the House of Lords (in particular Viscount Simon L.C.) made comments about how taxing statutes applicable to both England and Scotland should be applied, despite differences between the English and Scottish law of partnership. Those comments

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[60] Even though the bill giving rise to the 1890 Act was in existence for fifteen years, apparently the provisions regarding Scottish partnerships were inserted by the draftsman, Sir Frederick Pollock, at the eleventh hour, at the instigation of Lord Watson. For further information in this regard, see paragraph 6.6 and footnote 5 of the Law Commission op. cit.

[61] 24 TC 221.

were not strictly necessary for the decision but their thrust is clear, as is evident from the judgment of Viscount Simon L.C[62]:

> "So far as English law is concerned, it is indisputable that a partnership firm is not a single person, though a different view obtains in Scotland, and in construing a taxing Statute which applies in England and Scotland alike, it is desirable to adopt a construction of statutory words which avoids differences of interpretation of a technical character such as are calculated to produce inequalities in taxation as between citizens of the two countries".[63]

Bearing all this in mind, the court in *Major v Brodie* preferred the expert testimony for the taxpayer. It ruled that while a Scottish partnership entity owns the assets of that partnership beneficially, both the entity (in that case, B) and its partners carry on the partnership business. This creates the necessary "business in common" required by Section 1(1) and is consistent with Section 5 of the 1890 Act. Both of these Sections apply UK-wide[64].

It is not easy to analogise from the tax treatment of a Scottish partnership when classifying a non-UK putative "partnership", even if both have separate legal personality. Not only is a Scottish partnership an amalgam of civil and common law influences but also the special factors prompting the court to treat it as within Section 1(1) of the 1890 Act do not apply to a non-UK "partnership". In particular, there is no equivalent for such non-UK "partnerships" of Section 4(2) of the 1890 Act. *Ex parte Gibbs*[65] is equally inapplicable[66].

Furthermore, a Scottish partnership's legal personality has a different quality to the full juristic personality of a body corporate, as was made clear in the expert evidence in the *Brodie* case. For example, the partners are directly entitled to the firm's profits and are liable for its debts along with the firm itself. In effect they act as guarantors (unlike the shareholders of a UK unlimited company who cannot be sued directly by company creditors). Furthermore, a Scottish partnership probably

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[62] 24 TC 221 at 243-4.

[63] He went on to cite Lord Halsbury L.C. and Lord Watson in *Commissioners for Special Purposes of the Income Tax v Pemsel* [1891] AC 531, at 548 and 557.

[64] The findings of the English court as to Scottish partnership law are not Scottish legal precedent but merely findings of fact regarding the law of another jurisdiction (Scotland) based on contested expert evidence. In particular, Professor Murray disagreed with Professor Gretton, the expert appointed by the UK tax authorities. There was a similar clash of expert opinion on Scottish partnerships during the oral hearings before the Supreme Court in *Anson v HMRC* [2015] STC 1777. In that case, both sides were invited to make submissions on the nature of a Scottish partnership, because the taxpayer had sought to analogise between the legal personality of a Scottish partnership and that of a Delaware limited liability company. The taxpayer (unlike in *Major v* Brodie) argued that a partner in a Scottish partnership was only an agent of the partnership, which (being a separate legal person) was the sole principal carrying on the partnership business. Taxpayer counsel also argued that Section 5 of the 1890 Act effectively did not apply in Scotland to the extent it made a partner agent for fellow partners, rather than the firm. Scottish counsel for HMRC argued the opposite i.e. that a partner in a Scottish partnership was both a principal and an agent of the Scottish firm, for the purposes of carrying on that firm's business. The position of the taxpayer that a partner is only an agent of a Scottish partnership finds some support in paragraph 2.11, page 8 of the Law Commission op.cit. but is inconsistent with *Major v Brodie*. There is no further discussion of these points in the judgment of the Supreme Court in *Anson*. The author gratefully acknowledges the assistance of the staff of the UK Supreme Court when accessing the archived recordings of the oral argument before the Supreme Court in *Anson.*

[65] 24 TC 221.

[66] Somewhat similar arguments are made in Angelo Nikolakakis: "*Anson v HMRC: sour grapes and maple syrup – has the UK just adopted check-the box?"* [2015] BTR 538, especially at 549-550.

lacks perpetual succession. Whether these are characteristics of other non-UK "partnerships" with separate personality will depend on the facts and especially the relevant non-UK law.

Nevertheless, a Scottish partnership is a home-grown entity where, despite the separate legal personality of the partnership, partners are entitled to profits as they arise. This is important because that entitlement, which is fully respected for UK tax purposes, does not stem from partners having a proprietary interest in the Scottish partnership and its assets. Scots law, unlike English law, does not have any concept of equitable proprietary rights. It simply divides rights between rights "in rem" and contractual rights. As was pointed out in oral argument before the Supreme Court in *Anson v HMRC* [2015] STC 1777 and in the judgment of Lord Reed[67], the rights of a partner in a Scottish partnership are a "ius crediti" or incorporeal movable right, rather than a right in rem[68]. Other entities in other jurisdictions which purport to be partnerships may have similar characteristics: see 2.14.

2.9.7. The relevance of "perpetual succession" when defining a "body corporate" has already been discussed in 2.6. Assuming an entity lacking "perpetual succession" cannot be a "body corporate", does the presence of "perpetual succession" prevent an entity from being a "partnership" for UK tax purposes? It is not clear why this should be so[69], in which case the presence or absence of "perpetual succession" should not be a key demarcation between a "body corporate" and a "partnership". This is especially true bearing in mind that so many modern UK partnerships are now UK LLPs which are a form of body corporate enjoying special UK tax treatment. Hence they automatically exhibit "perpetual succession". There would therefore be a strange and discriminatory asymmetry if "perpetual succession" in respect of a non-UK entity (e.g. a UK LLP) meant that it could never be treated as a partnership for UK tax purposes. This would be especially strange because it can be largely a matter of legal drafting whether an entity exhibits "perpetual succession"[70].

Of course the idea of "perpetual succession" lends itself readily to an entity with a large and fluctuating membership and a centralised management. Such entities are often "bodies corporate". However, this is not necessarily so. The discussion in 2.10 centres on a French "partnership" entity which nevertheless has "perpetual succession" unless agreed to the contrary.

2.9.8. *Public recognition*

Another perceived fault line between a "body corporate" and a "partnership" is that the former is brought into being by an official public step (e.g. registration or a legislative act) whereas the latter is

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[67] See 2.15 below.

[68] Although Section 20 of the 1890 Act, which deals with partnership property, may give Scottish partners, like English partners, additional statutory rights to ensure that partnership property is held and applied in accordance with the partnership agreement. However, it is still the Scottish partnership itself which owns that property, unlike an English partnership.

[69] In paragraph 3.16 of their final report, the Law Commission op. cit. recommended that all English law partnerships should in future be legal entities with a presumption of their continuity on a change of partners. They regarded this as remedying a major flaw in the 1890 Act, which provides no such continuity. They did not regard such a change as preventing an entity being a partnership. Indeed such a change in partnership law would better match commercial reality (third parties generally contract with a major partnership as it exists from time to time and pay little heed to changes in membership). It would also align English law with the US Revised Uniform Partnership Act of 1994. The Law Commission's proposal has yet to be turned into law.

[70] See in this regard the discussion at 478-484 in Montagu: "*Anson* and Entity Classification revisited in light of Brexit" op. cit.

essentially a creature of contract, with little or no overlay in the form of public official approval. While this may reflect the way in which companies and partnerships are formed in the UK, there is no necessary reason why this should be so in other jurisdictions. Again, the example of the entity discussed in 2.10 is instructive.

Overall, it is increasingly difficult to find clear substantive differences between a partnership and a "body corporate". However, the best available distinguishing feature is whether members can claim a legal entitlement to underlying profits of the entity as they arise, even if this entitlement is only contractual[71]. If they can do so, this highlights a degree of member involvement and interest in the entity's underlying business which differs from the classic split between management and members in a "body corporate" and is consistent with the "business in common" concept in Section 1(1) of the 1890 Act[72]. With that provisional conclusion in mind[73], the next step is to review the case law which has attempted to classify various non-UK entities (leaving trusts aside for the time being) and in particular to determine if they are "tax-transparent".

The Case Law on entity classification pre-Anson

2.10 Dreyfus

2.10.1 In the late 1920's, the Court of Appeal heard the case of *Dreyfus v IRC* [74]. This was of course no relation to the infamous case which convulsed France at the start of the twentieth century. Rather it involved the UK income taxation of the grain trading activities of a French "societe en nom commandite" or "SNC" based in Paris but carrying on business, inter alia, in the UK. The SNC had two

[71] The author has seen statements by leading counsel that entitlement to profits as they arise cannot be the litmus test of whether an organisation is fiscally transparent because partners in a Scottish partnership do not have "that kind of property" in firm profits. However, those statements seem to misunderstand the nature of a Scottish partnership and in particular Sections 4(2) and 5 of the Partnership Act 1890. The same counsel went on to say that the key criterion determining "transparency" is the ability of members to remove profits from the organisation without any other person restricting that ability. The author has concerns with this statement. "Profit" is a notional accounting concept, not a property law concept. It is an abstract accounting measure of the health of a business. Profit may or may not be backed by actual assets e.g. cash. Therefore, what is meant by "removing profits", given that profits are not a legal asset which can be owned? Apparently, "removing profits" is not the same as an entitlement to profits. In that case, is it referring to distributions of assets to members in respect of profits (e.g. "drawings" in a partnership)? If so, it would be odd for transparency to hinge on an automatic entitlement to such distributions: any business organisation (including a partnership) will wish to restrict such distributions from time to time, in order to manage cashflow prudently.

[72] There is still an element of unreality about drawing such fundamental distinctions on the basis of whether members are entitled to underlying profits as they arise. This entitlement may be largely a legal and drafting fiction, and not only when the entity has separate legal personality (in which case the entitlement is purely contractual). Given the tight and secretive management of modern partnerships, including wide discretion exercised by management to adjust profit shares and retain cash, the idea that partners are entitled to profits as they arise is in many cases more theoretical than real. This has implications which will be discussed below.

[73] There was oblique legislative support for this conclusion in the definition of "corporate entity" in the (now repealed) "worldwide debt cap" rules in Part 7 TIOPA. Section 340 defined a "corporate entity" as a UK or non-UK "body corporate" or any other entity meeting conditions A and B. Condition A was that those with an interest in the entity must hold "shares in the entity, or interests corresponding to shares". Condition B was that the profit entitlement of each person with an interest in the entity "depends upon a decision that is taken by the entity or members of the entity, and is taken after the period in which profits arise". Part 7 was repealed to make way for the more stringent corporate interest restriction rules in Part 10 TIOPA.

[74] 14 TC 560.

members, the Dreyfus brothers, who also managed it. They were non-UK-resident. The case related to the pre-corporation tax era. Hence the SNC was subject to UK income tax on its UK trading profits. It had paid this tax. The question was whether the Dreyfus brothers could also be assessed to "supertax" on their putative shares of the profits of the SNC. "Supertax" was a predecessor of the higher rates of UK income tax and was payable only by "individuals". The UK tax authorities argued that the Dreyfus brothers were assessable to supertax because they were partners in a partnership i.e. the SNC. Then as now, partnerships were "transparent" for the purposes of taxing their income (although the mechanics of assessment were somewhat different). Hence an individual partner paid supertax on his or her share of the underlying income of the partnership, whether or not that income was distributed. The Dreyfus brothers successfully appealed against the supertax assessment on the basis that the SNC was not a partnership for UK tax purposes. The Court of Appeal agreed with them although it did not definitively decide what kind of entity the SNC in fact was. There are hints in the judgments that it was a type of "body corporate" but nothing definitive and it was not necessary to decide this point.

2.10.2 *Dreyfus* is so far the only significant UK tax case in which entity classification and "tax transparency" issues have been considered in the context of inbound UK investment. It also illustrates the approach of the UK courts when classifying non-UK entities, which differs from their approach when classifying UK entities. The non-UK tax treatment of the entity is not relevant. The nature of that entity is to be ascertained by reference to the non-UK law under which it is formed and the specific facts of the case, including any documentation constituting the entity. Therefore, the process of classifying non-UK entities and resolving “transparency” questions is very fact-sensitive. Evidence of the relevant non-UK law will often be crucial. Ascertaining that non-UK law is regarded as a finding of fact by the court, which may require evidence from suitably qualified experts. Once the entity’s nature has been worked out, one classifies it for UK tax purposes by seeking analogies with relevant UK entities. In short, the UK uses a “resemblance” approach to classify non-UK entities.

2.10.3 In the light of the expert evidence, the Court regarded the SNC as too structurally dissimilar from an English law partnership for it to be a "partnership" for UK tax purposes. Hence the members of the SNC were not partners and no supertax was payable. Particular points were as follows:

(a) The SNC entity did not come into being simply because its members agreed to form it, unlike an English or Scottish partnership. Rather the entity came into being by virtue of a process of public registration. This was very different to the process of forming a partnership in the UK.

(b) Once formed, the SNC entity was not in any sense the nominee or "alter ego" of its members. It and not its members carried on the business (unlike an English or, arguably, a Scottish partnership). So there was no "business in common". The new entity owned the assets and earned the income of the business. It incurred the liabilities in its own name and for itself alone. In short, its legal personality separate from its members was more absolute than that of a Scottish partnership, although members of the SNC could be directly liable for its debts to creditors if the entity itself failed to satisfy those debts. In that limited sense, the members' liability was more akin to that of partners in a Scottish partnership than to shareholders in a UK unlimited company.

(c) Members of the SNC had no automatic entitlement to its profits as they arose, unlike partners in an English or Scottish partnership. A prior resolution of the SNC was required before a member's entitlement to profit could crystallise. In that sense, the member's position was similar to that of a shareholder in a company.

(d) Members were not agents for each other, as in an English partnership. At best, they were agents of the SNC entity itself. This fourth point ignores the fact that in a Scottish partnership (a separate entity), partners are also agents of the entity and arguably not of each other (see, inter alia, the expert evidence of Professor Gretton in *Major v Brodie*[75]). A Scottish partnership is nevertheless a "partnership" for UK tax purposes, although (see 2.9.6), the status of a Scottish partnership is somewhat “sui generis”.

2.10.4 The following extracts from the two fully-reasoned judgments are illuminating.

Lord Hanworth MR stated[76]:

> ".....we must respect the foreign entity properly established, because it is not a mere matter of the 'lex fori'; it is a matter of the status which an entity brings over here with it. Now this being the case, how can it be said that in respect of this trade......it can be dealt with as the individual profits or individual trade of the two partners, when we are told in plain and clear words that the 'societe' does not owe its existence to the combination of the parties, that it is a legal person distinct from the individuals of which it is composed? ....it seems to me quite plain .....that [the profits] are being earned for the 'societe' or the French entity, and not for these men, and that these men ....’are not entitled to, and would not know what was their interest in the business over here unless and until that declaration had been made', according to the resolutions of which we have a translation in the case. ......**We have to recognise that it is not the business of these persons, they are not the persons who are carrying on the trade, and there is not merely an imaginary, but a legally constituted entity which is carrying on the business** [emphasis added]".

Lawrence LJ said[77]:

> "Without going through all the findings [of fact] in the case, I would point out one or two which to my mind really decide this case, the first being this, that **on complying with certain formalities, which, as I understand it, consisted of depositing a document with the Registrar of the Commercial and Civil Court and publishing a notice in the paper, an entity, to use a neutral term, springs into existence, and that entity is one which owns the property of the [SNC], and which incurs the liability in respect of the debts of the concern, and which has the sole right to receive the earnings of the concern, and has the control of the distribution of the profits. Added to that, it is plain on the findings that a member of that entity is not an agent for the others in carrying on the business of the concern** [emphasis added]. Without going into other findings...., those facts alone seem to me to be wholly inconsistent with the notion of a partnership as existing in this country, and that being the only question to be decided in the case, I think that is all that need be said. It is quite true that the position of persons who are members of such a Society as this may be likened more or less to that of shareholders in a limited or unlimited company in England, and also more or less to the position of partners in a partnership firm. But whatever be their position, they are not.....partners within the meaning of the Income Tax Acts".

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[75] [1998] STC 491
[76] 14 TC 560 at 577
[77] 14 TC 560 at 579

Lawrence LJ clearly saw some parallels between the position of a SNC member and the position of a shareholder in a UK unlimited company. The judgments at no point referred explicitly to Scottish partnerships[78]. However, as mentioned above, there appeared to be significant differences between the legal nature of this SNC and that of a Scottish partnership, even though both were separate legal persons.

2.10.5 A number of further comments need to be made about *Dreyfus.*

First, it has barely been discussed in subsequent cases. This may have something to do with the fact that (as we shall see) those cases mainly revolved around "transparency" questions in the context of outbound investment from the UK, where the narrow question at stake did not require the court to fully address whether an entity was a “partnership”.

Second, in deciding whether the SNC was a "partnership" or not, the judges very much worked from an English law paradigm of what a partnership is and how it is formed. Yet for UK tax purposes, there is no reason why the concept of "partnership" should be limited to entities formed under the laws of the UK. Hence the Court of Appeal’s approach seems much too parochial. Other jurisdictions, especially civil law jurisdictions such as France, have different legal cultures and constructs. The legal form and formation procedure of a "partnership" under French law may therefore differ significantly from the UK equivalent. A less parochial approach underlies the Supreme Court decision in *Anson*, which is discussed in 2.15.

Interestingly, a less parochial application of UK tax concepts to non-UK legal structures was also recommended by the Court of Appeal a few years after *Dreyfus* in *Ryall v The Dubois Company Ltd* [79]. In that case, the key question was whether a UK taxpayer could claim the favourable remittance basis of taxation on distributions to it as a member of a German GmbH (the German approximation of the UK private limited company). If its member's interest constituted "stocks" or "shares" in the GmbH, then the remittance basis was not available, under the law as it then stood. On the evidence, there were some notable differences between the concept of a "share" under UK company law and the rights and liabilities attaching to a member's interest in a GmbH. However, as Romer LJ said[80]:

> "Here it is quite plain that the words 'stocks' or 'shares' cannot be used in their ordinary meaning as the words are used in this country, because, under the Rule in question, they have to be used in connection with foreign companies and, therefore, it is a question of law as to what their meaning is[81]."

[78] Although Lord Hanworth MR may have had a Scottish partnership in mind when he alluded to an “imaginary” entity.

[79] 16 TC 431

[80] 16 TC 431 at 443. The end of this remark is a reminder that all UK entity classification and tax transparency questions boil down to the correct legal interpretation of whatever UK tax rule or concept is in play. In *Dreyfus,* the relevant concept was that of "partner". However, interpreting that rule or concept requires a full understanding of the relevant non-UK arrangement in the light of its governing law and, in the author’s view, taking full account of the role that the entity in question plays in its legal system of origin.

[81] Somewhat surprisingly, *Ryall* was not cited in the Special Commissioner’s decision in *South Shore Mutual Insurance Co Ltd v Blair* [1999] STC (SCD) 296. In that case, the court ruled that so-called “founder members’ deposits” of an English company limited by guarantee were not “issued share capital by whatever name called)”

Third, the UK tax authorities do not follow *Dreyfus* and typically regard a SNC as "transparent" for UK tax purposes[82]. Apparently they believe that the expert evidence was flawed and that under French law, SNC members **are** entitled to profits as they arise. Hence (given the central question in *Dreyfus*), they regard the SNC as "analogous to a partnership" for UK tax purposes, despite the way in which a SNC is formed (by registration), the fuller nature of its legal personality, the lack of mutual agency and the manner in which it conducts its business[83].

Their views on the correctness of *Dreyfus* are consistent with the author's views about the most important distinction between a "partnership" and a "body corporate" for UK tax purposes. However, they are not easy to reconcile with HMRC's refusal to grant a UK foreign tax credit in respect of a member's interest in a Delaware LLC in *Anson,* discussed in 2.15. The LLC in question bore many of the same hallmarks as the SNC in *Dreyfus,* although the SNC members had direct liability for its obligations (unlike the members of the LLC, who had limited liability anyway). In this regard, paragraph 1673 of the old International Tax Handbook further muddies the waters because it later says: "We look for indicators as to whether the Association carries on the business itself or whether the participators do so jointly; and whether the profits accrue directly to the participators or whether they accrue to the association which then distributes them to the participators". The first part of this quoted statement seems at odds with the earlier statement that the SNC in *Dreyfus* was "analogous to a partnership", despite the Court of Appeal's contrary decision. In particular, that SNC did carry on the business itself and there was no mutual agency between its members: see 2.10.3(b) and (d).

In any case, the UK tax status of a particular SNC will depend on its detailed structure, and especially on the detailed legal form of a member's interest in it. Those details may differ from SNC to SNC. In that sense, *Dreyfus* was a decision limited to its specific facts.

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within what is now Section 1119 CTA 2010. Therefore, they were not "ordinary share capital" for the purposes of creating a "group" for corporation tax purposes. The company had been formed before the 1980 prohibition on companies limited by guarantee having a share capital. It had nevertheless been formed without an explicit share capital and the court was not prepared to treat the "founder members' deposits" as such. The latter had some features of capital but also had subordinated debt-like features and had not been subscribed pursuant to the company's "memorandum of association". Overall this decision (which is not a binding precedent) defines "ordinary share capital" quite conservatively, in a purely UK context and relying quite heavily on the formalities of UK company law. *Ryall* sensibly suggests a different approach, especially when dealing with non-UK entities. That approach is now reflected in Section 259NE(4)(a) TIOPA, which defines a "partnership" as "includ[ing] an entity established under the law of a territory outside the United Kingdom **of a similar character to a partnership** [emphasis added]". However, this definition only applies for the purposes of Part 6A TIOPA, i.e. the rules which counteract the UK tax benefits of certain hybrid mismatches. HMRC published guidance (International Tax Manual INTM550630, accessed 3 June 2020) states that "An entity regarded as transparent is not necessarily of a similar character to a UK partnership…..This subsection is intended to ensure that the treatment of non-UK partnerships, for Part 6A purposes, is consistent with the treatment of UK partnerships **and not to extend the definition of partnership** [emphasis added]". The highlighted words are not entirely helpful and, in the author's opinion, are wrong if they are meant to suggest that the approach in *Ryall* does not apply.

[82] This is stated in some detail at paragraph 1673 of the old International Tax Handbook (now archived) published by the UK tax authorities. The Canadian tax authorities take a similar position: see Angelo Nikolakakis op. cit. at 551 footnote 56.

[83] There are also indications from the case stated in *Dreyfus* (see 14 TC 560 at 564) that the death or legal incapacity of a partner would not always lead to the dissolution of the SNC. In short, there was "perpetual succession".

Furthermore, as discussed in 2.14 below, HMRC have produced a list of criteria which they regard as relevant when deciding whether a non-UK entity is "transparent" or not. The ongoing status of that list is moot following the Supreme Court decision in *Anson* discussed in 2.15. However, if one applies that list to the facts in *Dreyfus* (and ignores HMRC's concerns mentioned above about expert evidence), it is hard to fault the Court of Appeal's conclusion[84]. That may not amount to much because, as discussed in 2.14, the author has considerable doubts about the HMRC list.

Fourthly, statements have been made in the past that *Dreyfus* is authority for the proposition that a non-UK entity with separate legal personality cannot be "transparent" for UK tax purposes. This not only ignores the existence of Scottish partnerships but is a huge oversimplification of the reasoning in *Dreyfus*. This hinged on much more than the separate legal personality of the SNC.

However, it remains an unsatisfactory case because the court never developed a full understanding of where a SNC fits into the French law of business organisations. The forms which partnerships take under civil law systems largely reflect key differences between the law of agency under those systems compared to English law. This is discussed in more detail in 3 below. For present purposes, it suffices to say that under French law, a SNC is a "formal" partnership[85] whose creation as a separate fully-disclosed entity by registration is mainly a means of ensuring that the activities of partners bind the entire partnership. Under English law, this would not be necessary because the law of agency is different. In other words, this registration procedure under French law is not about creating an entity where there is a rigid separation between the activities of the entity and those of its members. Hence analogising with the process of incorporating a UK body corporate seems faulty[86].

2.11 Oxnard

2.11.1 The nature of a civil law partnership was further considered by the Court of Appeal in a non-tax case, *Oxnard Financing SA v Rahn and others* [87]. *Dreyfus* was not cited and the case considered a Swiss general partnership[88], not a French SNC.

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[84] In this regard see the comments in "The English Dreyfus Case - categorisation of a French SNC for tax purposes in the UK". John F. Avery Jones CBE. Fiscalite et entreprise: politiques et pratiques. Melanges en l'honneur de Jean-Pierre Le Gall. Dalloz. Paris 2007 at 325.

[85] For further detail in this regard, see Avery Jones: Partnerships op. cit. [2002] BTR 375 at 380 fn 26, 381, 389 and 394-6. That article also makes clear the differences **between** civil law jurisdictions regarding the way in which "formal" partnerships are created and what form such a partnership ultimately takes. For example, a French "formal" partnership is regarded as having legal personality under French law. This is not necessarily so as regards its German, Dutch or Swiss equivalents. The Dutch position is closer to the English law position (registration is a means of giving information to third parties about the entity but confers no status as such on a "vennootschop onder firma" or VOF, which lacks legal personality under Dutch law, although has extensive legal capacity – see 7.3.2). In Germany, a "formal" partnership can have full legal capacity but not legal personality (a distinction alien to common lawyers) if its members have liability for the entity's debts.

[86] Although an incoming member of a SNC is liable for existing debts of the SNC, which is regarded as carrying on the business itself. This differs from the position regarding an incoming Scottish partner or an incoming member of a Dutch VOF: see Avery Jones: Partnerships op. cit. [2002] BTR 375 at 405.

[87] [1998] 3 All ER 19. See also Robert Kent [1999] BTR 125.

[88] For further detail regarding such Swiss partnerships, see Avery Jones: Partnerships op. cit [2002] BTR 375 at 381 fn 26, 394. Apparently, as in Germany, a Swiss partnership can have legal capacity, but not legal personality, if its members can be directly liable for the entity's debts, as they typically are. This distinction between full legal capacity and legal personality is alien to an English lawyer.

The underlying issue was the procedure for suing, in the English courts, the Swiss partnership and its members. If the entity were a corporation, then it would have been correct to sue the entity itself and not its members.

Uncontested evidence of Swiss law was provided to the Court. On that basis, it concluded that the entity was a general partnership enjoying a high degree of legal personality enabling it to contract in its own name and to own assets. It was not however a corporation and consequently did not have legal personality under Swiss law, which (unlike English law) does not always treat an entity with full legal capacity as being a legal person. Creditor claims against the entity were primarily enforceable against the entity itself and its assets, with the partners having full direct liability to creditors but only on a secondary basis. This is similar to the position of Scottish partners. There was no consideration (unlike *Dreyfus*) of when and how the partners were entitled to the entity's underlying profits, nor the way in which it carried on business.

In reaching its decision, the Court relied heavily on an earlier Court of Appeal decision on litigation procedure in *Von Hellfeld v Rechnitzer and Mayer Freres* [89]. That case did concern a French SNC and the Court in that case concluded on the basis of expert evidence that the SNC in question was a partnership. As Phillimore LJ stated at 754-5:

> "**[The expert evidence is] not enough to shew** - which is necessary for this purpose - **that a societe en nom collectif is like a corporation in this respect, not merely that it has a separate persona, but that it has separate ownership of property and separate liability from the ownership or liability by or of the persons composing the aggregation**". [Emphasis added].

Again there was no consideration (unlike *Dreyfus*) of when and if the SNC members were entitled to its underlying profits, nor of how the entity was formed or carried on business. The conclusion was of course the opposite of that in *Dreyfus.* This highlights how much such cases turn on questions of fact and in particular the quality of the expert evidence on the relevant non-UK law.

2.11.2 Not being tax cases, it is not clear how much weight can be placed on *Oxnard* and *Von Hellfeld*. Furthermore, details of the expert evidence were quite sparse, even though evidence of non-UK law was key. Nevertheless, both cases show that the UK courts have been willing to treat as partnerships non-UK entities with separate legal personality (or at least, in the case of a Swiss general partnership, the independent legal capacity which English lawyers, and other lawyers outside the German civil law tradition, would equate with separate legal personality). The courts in these cases also seemed to understand that it is important to evaluate what legal personality does and does not entail, in the precise circumstances. Interestingly, both entities concerned exhibited a degree of legal personality which was apparently more developed than that which exists in a Scottish partnership. In particular, the SNC carried on the relevant business. However, as Phillimore LJ makes clear, there was not a sufficient distinction between the rights and liabilities of the entity, versus those of its members, to treat it as a body corporate, which is a special kind of legal person where there is a more absolute dividing line between the entity and its members.

[89] [1914] 1 Ch 748.

In both these cases, the non-UK entities did not benefit from the special factors which have prompted the UK courts to stress that a Scottish partnership is a partnership within Section 1(1) of the 1890 Act (and hence for UK tax purposes).

2.12 Memec v IRC

2.12.1 In the late 1990's, the High Court and the Court of Appeal considered a major question of tax transparency in *Memec plc v IRC* [90]. The question arose in relation to outbound investment by a UK-resident company which owned German subsidiaries. In order to reduce the German corporation tax paid by its subsidiaries, the UK-resident company entered into a "stille Gesellschaft" (or "silent partnership”[91]) agreement with the German subholding company which directly owned the other German subsidiaries. Under that agreement, the UK-resident company obtained the right to payment of 87.84% of the annual profits of the "silent partnership". In return, it paid a capital contribution to the German subholding company.

2.12.2 In the High Court, Robert Walker J (as he then was) described a "silent partnership" as follows[92]:

> "The essential points are that the silent partner (stille Gesellschafter) makes a capital contribution to a commercial enterprise run by another person who is designated as the owner (Inhaber). The owner remains the owner of the business assets and of the income from those assets as it accrues. The silent partner has no proprietary interest in the assets but has a contractual right to payment of his share of the annual profits (if any) as shown by the partnership accounts, and can sue for damages in the event of any misappropriation. The owner runs the business, though the silent partner has access to information about it. The silent partner is not responsible for liabilities of the partnership beyond the amount of his contribution, but his share of any loss will be debited to his contribution and must be made good out of his share of the profits of later years before any share of profits is distributed to him. On termination of the partnership, the silent partner gets a return of his capital contribution, so far as it has not been lost. A silent partnership has no separate legal personality under German law. Its existence is often unknown to customers dealing with the owner".

The "silent partnership" in *Memec* was [93] the more common type known as a "typical" silent partnership, created under Article 230 of the German Commercial Code[94]. A rarer variant also exists known as an "atypical" silent partnership. This distinction between “typical” and “atypical” silent partnerships is a German tax law distinction, although it reflects certain commercial differences. In particular, under an “atypical” silent partnership, the silent partner may in addition be given a vote in partnership affairs and a share of goodwill[95] or of appreciation in the assets of the partnership[96]. The

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[90] [1996] STC 1336, followed by [1998] STC 754.
[91] “Gesellschaft” does not always mean “partnership” in German. It can also mean “company” or “society”, in much the same way that in the past, English has used “company” to refer to both incorporated and unincorporated bodies.
[92] [1996] STC 1336 at 1345.
[93] See John F. Avery Jones “Memec plc v IRC” [1997] British Tax Review 188.
[94] See Avery Jones: Partnerships op. cit. [2002] BTR 375 at 381 fn 27.
[95] See Avery Jones: Partnerships op. cit. [2002] BTR 384 at fn 38.
[96] See “Hybrid Financing” Bureau Francis Lefebvre, Loyens & Volkmaars, Oppenhoff & Raedler (IBFD Publications BV, Editions Francis Lefebvre 1996) at 4.6.2.2.

nature of its interest more closely resembles that of a partner, while a "typical" silent partnership more closely resembles a profit-participating loan. However such loans ("partiarische Darlehen") are in fact a separate concept under German commercial law. They are not created under Article 230 of the Commercial Code but are governed by Section 607 of the Civil Code. Moreover, the lender does not participate in losses nor in the value of assets, unlike a silent partner[97].

The share of profits payable by the German subholding company in *Memec* to the UK-resident company was deductible within the German subgroup for German corporation tax purposes. It was not, however, deductible for the purposes of the separate German municipal "trade tax" on the subgroup's income. In order to ensure that the whole arrangement did not create additional UK corporation tax, it was important that a UK foreign tax credit for this "trade tax" was available to the UK-resident company. Otherwise, the German corporation tax saving would be neutralised by increased UK corporation tax[98].

2.12.3 A number of unsuccessful arguments were put forward to show that a UK foreign tax credit for the underlying "trade tax" was available. The first argument was that the "silent partnership" was "transparent" for UK tax purposes. If so, what the UK-resident company received from the "silent partnership" consisted of a share of the very dividend income received by its German subholding company from its own underlying German subsidiaries. If the UK-resident company was receiving a share of those dividends, it could claim a foreign tax credit for the "trade tax" on the German profits which funded those dividends. It was therefore not strictly necessary to decide whether the "silent partnership" was a "partnership" for UK tax purposes, although if it was, then it would be easier to treat it as "transparent" because of how the UK taxes partnerships.

2.12.4 <u>The High Court</u>

In the High Court[99], the judge noted the special circumstances of a Scottish partnership but stressed that the key issue was whether the "silent partnership" was a "transparent" arrangement and not whether it was a "partnership" within Section 1(1) of the 1890 Act. Even though the "silent partnership" lacked legal personality, it was not transparent because the "stille Gesellschafter" had no proprietary interest in the shares owned by the German subholding company nor in the dividends to which they gave rise. Therefore its right to a share of those dividends was a separate income source, and not dividends from the German subsidiaries.

The judge went on to say[100]:

> "Transparency is normally associated with a situation where the ultimate recipient of the income in question has a beneficial interest in it from the start, and moreover the income is not transmuted at some intermediate stage by the need for trustees to exercise a discretion or by its being packaged so as to reach the ultimate recipient in the form of a fixed annuity".

[97] See "Hybrid Financing" op. cit. at 4.5.2.1.
[98] The whole arrangement was a form of cross-border hybrid financing, the aim being that an additional tax deduction in Germany did not correspondingly increase the tax liability of the UK finance provider.
[99] For an extended discussion of the High Court decision, see John F. Avery Jones "Memec plc v IRC" [1997} British Tax Review 188.
[100] [1996] STC 1336 at 1353j.

2.12.5 The Court of Appeal

Unlike the High Court, the Court of Appeal focussed much more closely on whether the "silent partnership" fell within Section 1(1) of the 1890 Act and hence was "transparent" for UK tax purposes. The main judgment was given by Peter Gibson LJ. On the "transparency" point, he made the following remarks:

> "The relevant characteristics of an ordinary English partnership are these: (1) the partnership is not a legal entity; (2) the partners carry on the business of the partnership in common with a view to profit (see s1(1) of the Partnership Act 1890 (the 1890 Act)); (3) each does so both as principal and (see s 5 of the 1890 Act) as agent for each other, binding the firm and his partners in all matters within his authority; (4) every partner is liable jointly with the other partners for all debts and obligations of the firm (see s 9 of the 1890 Act); and (5) the partners own the business, having a beneficial interest, in the form of an undivided share in the partnership assets, including any profits of the business.
>
> A limited partnership differs relevantly only in the following respects: (a) characteristics (2) and (3) above are modified in that the limited partner takes no part in the management of the partnership business (see s 6(1) of the Limited Partnership Act 1907), the ordinary partners acting on his behalf as well as on their own behalf; and (b) the limited partner on entering the partnership is obliged to make a contribution of a sum or sums as capital or property of a stated amount and characteristic (4) above is modified in that the limited partner is only liable up to, but not beyond, the amount so contributed[101].......
>
> [A] Scottish partnership differs in the following respects: (a) characteristic (1) above does not apply: the partnership is a legal entity distinct from the partners of whom it is composed, but an individual partner may be charged on a decree of diligence directed against the firm, and on payment [by that partner] of the firm's debts is entitled to pro rata relief from the firm and his other partners (see s 4(2) of the 1890 Act); (b) characteristic (3) above is also modified in that the partner is not a principal but is an agent of the firm and his partners[102]; (c) characteristic (4) above is modified in that the partner is not only jointly but also severally liable; (d) characteristic (5) above is modified in that the assets of the partnership are vested in the partnership legally and beneficially, the interest of each partner in the partnership property being described.....as 'a pro indiviso right in the stock or common fund vested in the partners, firstly for payment of the company debts and then for the partners themselves'......However, the partner has an interest which may be arrested (or seized) by his separate creditors, but only in the hands of the firm, and specific property of the partnership cannot be arrested by such creditors......
>
> The justification for treating a Scottish partnership as transparent, though it may be less obvious because of the interposition of the partnership as a legal entity between the partners and the profits of the partnership, can be perceived in that in substance the position of the partners in

[101] The rules on limited partner contributions have in fact been modified since 2017 in relation to so-called "PFLPs": see 2.9.3.

[102] The expert evidence for the taxpayer in *Major v Brodie* [1998] STC 491 suggests that this point about the Scottish partner not being a principal is highly debateable. It was also doubted by Scottish counsel for HMRC before the Supreme Court in *Anson v HMRC* [2015] STC 1777, who had in fact appeared as junior counsel for the taxpayer in *Memec.*

relation to the profits is the same as in an English partnership: those profits are earned by the partners carrying on business in common together[103]and are shared in the same way and the partners, whilst not directly owning the business and assets, indirectly do so and have an indirect interest in them which is capable of being arrested by the creditor of a partner.

A silent partnership, whilst being similar to an English partnership in not being a separate legal entity, differs from both English and Scottish partnerships in a number of respects. [Robert Walker J] considered the decisive point to be the absence of any proprietary right, legal or equitable, enjoyed by [the UK-resident taxpayer] in the shares of the [German] subsidiaries or in the dividends accruing on those shares. That is certainly a strong point of distinction from an English partnership, though it is less obviously so in the case of a Scottish partnership. But even a Scottish partner has an (indirect) interest in the profits of the partnership as they accrue as well as in the assets of the partnership. In a real sense the profits and assets are the profits and assets of the partners, the firm, their collective alter ego, merely receiving those profits and holding those assets for the partners who are the firm[104]. They are jointly and severally liable for the firm's debts. In contrast, though a silent partner is indirectly interested in those profits, in that his entitlement to a share of the profits (or his obligation in respect of the losses) will be computed by reference to the profits of the owner at the end of the year, his interest is purely contractual. A clearer distinction is the point advanced by [counsel for the UK tax authorities] that, **unlike in an English or Scottish partnership, in the silent partnership no business is carried on [by the UK-resident taxpayer and the German subholding company] in common with a view to profit** [emphasis added]......The liabilities of the business are those of [the German subholding company] alone, though (the UK-resident company) can be called on by [the German subholding company] to bear its share of losses computed at the end of the year to the extent of its capital contribution. **To a third party, [the UK-resident taxpayer's] role in the silent partnership is irrelevant and may not be known** [emphasis added].

The position of [the UK-resident taxpayer] seems to me to be that of a purchaser who, for a consideration consisting of the contribution of a capital sum and an undertaking to contribute to losses of the owner of a business up to the amount of the contribution, purchases a right to income of a fluctuating amount calculated as a share of the annual profits of the business. Neither in English or Scottish law would that leave [the UK-resident taxpayer] a partner with the German subholding company".

2.12.6 A number of comments arise from these dicta:

First, as in the High Court, *Dreyfus* was not discussed. However, the Court of Appeal was correct to focus more on the "partnership" issue than the High Court judge had done. If there were a "partnership" by UK standards, then income tax transparency should have followed whether or not the UK-resident taxpayer had a proprietary interest in the shares owned by the German subholding company and the dividends accruing on them.

[103] This last point to some extent conflicts with the judge's earlier comment that partners in a Scottish partnership are only agents of the firm, not principals.
[104] If this comment is meant to suggest that a Scottish partnership holds its assets as a trustee or nominee for its partners, then it is not correct, although dicta of Peter Gibson LJ earlier in the passage quoted suggest that this was not his intention.

The Court went to some length to demonstrate the "interest" of the partners of both an English and Scottish partnership in the underlying partnership income and assets. This part of the Court's reasoning is less convincing, at least as it relates to Scottish partnerships. Furthermore, it is of limited relevance when dealing with a non-UK entity. As already discussed in relation to *Major v Brodie*[105] the most obvious reasons for treating Scottish partnerships as tax-transparent "partnerships" are Scotland-specific: in particular, the definition of "firm" in Section 4(2) of the 1890 Act, together with the judicial desire to apply UK-wide tax legislation uniformly across the United Kingdom. As *Major v Brodie* illustrates, Scottish academic opinion is not uniform on whether a partner in a Scottish partnership is both a principal and an agent, rather than just an agent of the firm entity. It is therefore not easy to analogise from the example of Scottish partnerships when classifying non-UK entities which claim to be partnerships.

Second, although the Court of Appeal was right to address more comprehensively the partnership issue in order to resolve the transparency question, their answer seems too parochial. Functionally, the "silent partnership" they were considering was quite similar to an English limited partnership formed under the Limited Partnerships Act 1907. In particular, it lacked legal personality; the silent partner took no part in management; and the silent partner’s effective liability was limited to its capital contribution, which it made in exchange for a predefined return measured directly by reference to the underlying income of the arrangement. The silent partnership was not identical to an English law limited partnership: the silent partner had no direct obligations to creditors of the underlying business and its identity may well not have been known to them. Nor was the silent partnership officially registered, unlike an English law limited partnership[106].

Germany has other forms of limited partnership such as the Kommanditgesellschaft ("KG") and the GmbH & Co KG[107] or indeed the "atypical" variant of a silent partnership. These arguably bear an even closer resemblance to an English limited partnership than does a “typical” silent partnership. Yet that alone should not prevent a “typical” silent partnership from being classified for UK tax purposes as just another form of limited partnership, structured in a somewhat different way to its UK analogue because German civil law (and especially the civil law of agency) is different from the English common law[108]. A less insular approach to the meaning of "partnership" for entity classification purposes, with less emphasis on UK paradigms, would be consistent with *Ryall v The DuBois Company Ltd* [109]. Such an approach requires a closer examination of where a “silent partnership” fits into the range of German legal entities or arrangements.

Third, since *Memec*, the relevant tax legislation has been amended to make even clearer that a "partnership" is normally treated as "transparent" for direct tax purposes. For income tax, Section 848 ITTOIA 2005 states that "Unless otherwise indicated (whether expressly or by implication), a firm is

[105] [1998] STC 491.
[106] There was presumably no need for such registration (whose sole purpose is to trigger the limited liability of limited partners in a limited partnership formed under the Limited Partnerships Act 1907). Even without registration, the silent partner had no direct obligations to creditors of the underlying business anyway.
[107] This is a limited partnership where (as in most UK limited partnerships) the general partner is a purpose-formed private company with limited net asset value of its own. German law even contains a hybrid entity comprising both partnership and company features called the Kommanditgesellschaft auf Aktien or KGaA. The interests of limited, but not general, partners in a KGaA take the form of share capital. There is no clear UK analogue for a KGaA, which is taxed as a body corporate in Germany: see “Hybrid Financing” op. cit. at 4.6.1.
[108] For more on this, see 3.8 below.
[109] 16 TC 431.

not to be regarded for income tax purposes as an entity separate and distinct from the partners"[110]. For corporation tax, Section 1258 CTA 2009 is effectively identical. Section 59 TCGA 1992 performs the same function for both capital gains tax and corporation tax on capital gains.

Fourth, *Memec* prompted the UK tax authorities to publish for the first time a list of criteria which they regarded as key when classifying non-UK entities as "transparent" or not. That list is discussed in 2.13.

Fifth, *Memec* needs to be considered in the light of the *Anson* litigation: see 3.8 below.

2.13 The HMRC List

2.13.1 This list is now set out in HMRC's International Tax Manual[111]. It has no statutory force but purports to provide guidance on how to classify a non-UK entity as opaque or transparent, taking relevant judicial decisions into account. HMRC stress that the expressions "opaque" and "transparent" are not coterminous with "body corporate" and "partnership". That is clear from *Memec* itself: the opaque "silent partnership" lacked legal personality so could not be a body corporate. Furthermore, as discussed in 4, certain trusts can be transparent for UK tax purposes: transparency is not limited to partnerships.

The six items on the HMRC list are as follows:
(i) Does the foreign entity have a legal existence separate from that of the persons who have an interest in it?
(ii) Does the entity issue share capital or something else, which serves the same function as share capital?
(iii) Is the business carried on by the entity itself or jointly by the persons who have an interest in it that is separate and distinct from the entity?
(iv) Are the persons who have an interest in the entity entitled to share in its profits as they arise; or does the amount of profits to which they are entitled depend on a decision of the entity or its members, after the period in which the profits have arisen, to make a distribution of profits?
(v) Who is responsible for debts incurred as a result of the carrying on of the business: the entity or the persons who have an interest in it?
(vi) Do the assets used for carrying on the business belong beneficially to the entity or to the persons who have an interest in it?

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[110] This is the 2005 rewrite of Section 111 Income and Corporation Taxes Act 1988. Equivalent language was inserted as Section 111(1) of the 1988 Act, in 1994, on the switchover to income tax self-assessment. That switch led to separate income tax assessments on individual partners (rather than a joint assessment on all partners in the partnership name, which was provided for in Section 111, before it was revised in 1994). A partnership therefore became less "entity-like" for UK tax purposes when individual self-assessments replaced joint assessments: see paragraphs 24-7 of Henderson LJ's judgment in *Peter Vaines v HMRC* [2018] STC 297, in which he stressed that in a partnership, there is a single business carried on by all the partners. Despite the new and clearer statutory language, a partnership was regarded as "transparent", for income and corporation tax purposes, before 1994. Indeed, since the inception of income tax, the underlying partnership business (and not the partnership itself) has been regarded as the "source" of a partner's income.

[111] INTM 180010 www.gov.uk/hmrc-internal-manuals/international-manual/intm180010 accessed 14 November 2018.

All six items are apparently to be considered in the light of the non-UK commercial (but not tax) law governing the entity. No one item is conclusive although items (iii) and (iv) apparently carry particular weight.

2.13.2 The ongoing status of this list[112] is unclear following the *Anson* litigation, which is discussed at 2.14.

The phraseology of some items is curious and the questions posed are too binary. For example, the examples of Scottish partnerships and French SNCs show that there can be varying degrees of separateness between an entity with separate legal personality and its members: does item (i) adequately take account of this? Similar points can be made about items (iii), (v) and (vi). In relation to item (iii), *Major v Brodie*[113] suggests that in some cases, both the separate entity and its members carry on the relevant business. It is not a question of "either or". Similarly, as was clear in both *Major v Brodie*[114] and *Oxnard v Rahn*[115], there can be cases where the debts of the separate entity are also the debts of its members (who may be primarily or secondarily liable to the entity's creditors). In relation to item (vi), the Court of Appeal in *Memec* said (hesitantly) that partners in a Scottish partnership have an "interest" in its underlying assets, but also recognised that those assets are beneficially owned by the partnership entity. It is not clear whether item (vi) reflects this possibility, which is likely to arise in the many jurisdictions (e.g. the states of the US) whose concept of partnership entails separate legal personality.

Overall the list of transparency criteria seems too heavily influenced by the English common law conception of partnership, where there is no separate legal personality and the partners alone carry on the business and own its assets. This seems too restrictive for a list which is intended to guide the classification of non-UK entities. These are unlikely to align easily with such common law preconceptions, especially if they originate in countries where (as in the United States) "partnerships" routinely have legal personality or (as in Germany) a degree of legal capacity which English law would regard as tantamount to legal personality, even if local law does not. A good example of the restrictiveness of the HMRC criteria is the SNC in *Dreyfus*[116]. According to HMRC's revised thinking, such an entity should be treated as "transparent" for UK tax purposes because the expert evidence was defective and the SNC members were in fact entitled to its profits as they arose: see item (iv) in the list. Even if one assumes that this is correct, a SNC remains an entity formed by registration which is distinct from its members; it rather than its members carries on its business and beneficially owns its assets; and it is responsible for its business debts even though its members can be liable for them concurrently. Hence only one item on the list (admittedly a stronger factor) clearly points towards the transparency of a SNC[117].

[112] The list is also discussed in Avery Jones: Partnerships op.cit. [2002] BTR 375 at 419-422 in which the authors regard the HMRC criteria as "not particularly successful when applied to civil law partnerships, especially those where legal capacity is not equated to legal personality".
[113] [1998] STC 491.
[114] [1998} STC 491.
[115] [1998] 3 All ER 19.
[116] 14 TC 560.
[117] As discussed in 2.9.5, item (iv) may also be of particular importance in distinguishing a "body corporate" from a "partnership", even though the distinction which it draws is largely semantic.

The list does not include other items which might indicate the existence of a body corporate (and hence opacity). For example, there is no reference to whether member liability is limited or whether the entity continues in existence regardless of changes in its membership ("perpetual succession"). Similarly, while item (ii) focusses on whether the entity has share capital[118], there is no emphasis on the freedom to transfer that share capital[119]. Hence it is hard to see the list as more than an incomplete series of pointers intended to assist a holistic enquiry. Furthermore, there is limited guidance on the relative weighting to be given to these pointers.

2.13.3 HMRC have also published[120] a list of entities whose status as transparent or opaque they have considered, but only when reviewing the UK tax treatment of members of such entities[121]. Again this list does not consider whether entities are bodies corporate or partnerships. Nor is any detail provided about the precise circumstances in which such entities were considered and the evidence of non-UK law used to reach the determination. This is presumably to protect taxpayer confidentiality but there is no reason why the list should not refer, on a case by case basis, to the general factors which guided HMRC to their conclusion. The equivalent Dutch list discussed in 7 is much more helpful in this regard.

Hence this HMRC list should be treated with caution, especially as a number of the determinations are quite old. Furthermore, it needs updating to cover all the situations which HMRC have considered. A notable recent omission is a so-called "Guernsey LP Inc", which HMRC have ruled (in 2010) to be transparent for the purposes of taxing its UK-resident member. This vehicle has been used in investment fund structures and is a newer form of Guernsey limited partnership where the general partner can irrevocably elect, when the entity is formed, to treat it as a legal person under Guernsey law. Furthermore Guernsey law makes clear that such a limited partnership is not just a legal person but also a "body corporate" under local law: hence the "Inc" in its name. It also appears to continue in existence, even if there is a change of partners i.e. there is perpetual succession. These features differentiate it from a Scottish partnership and make HMRC's ruling somewhat surprising. That ruling offers no insight on whether the relationship between member and entity is such that, despite legal personality and perpetual succession, the entity cannot be properly regarded as a body corporate for UK tax purposes.

Not surprisingly, the list regards a silent partnership as opaque. Likewise a US limited liability company: hence the *Anson* litigation discussed in 2.14. More surprising is the readiness of HMRC to concede transparency in relation to civil law "partnership" entities, such as the SNC and the Groupement d'Interet Economique, which appear to have a more separate legal personality than Scottish partnerships, although their stance may well be linked to their revised thinking on *Dreyfus*. The HMRC approach is the same in relation to most partnerships and limited partnerships formed

[118] At least one commentator regards this emphasis on the existence of share capital as outmoded, not least because under UK corporate law, it is now possible to create potentially "opaque" entities, such as UK LLPs, in which the members' interests cannot be classified as share capital: see Montagu: "*Anson* and Entity Classification Revisited in Light of Brexit: can an LLC Constitute a 'Body Corporate'?" op. cit. [2016] BTR page 469 fn 16 and page 486. There does in any case seem to be considerable overlap between items (ii) and (iv) on the HMRC List.

[119] By contrast, this can be a relevant factor for the Dutch tax entity classification rules, just as it was under the pre-1997 US Federal entity classification rules. The latter also emphasised "continuity of life" (i.e. perpetual succession) and limited liability. See 7 for a more extended discussion.

[120] In the International Manual at INTM180030 (accessed 4 June 2020).

[121] In short, these entities have only been considered in the context of outbound investment from the UK.

under the laws of the USA. These again almost always have legal personality and more clearly so than a Scottish partnership. By contrast, HMRC regard a Jersey limited liability partnership (which also has separate personality and carries on the partnership business) as opaque. This is presumably the determination which led to an unsuccessful taxpayer challenge, via judicial review, in *R v IRC ex parte Bishopp* [122]. The judge in that case did not rule on the UK tax classification of the entity in question, even though he heard argument on the point[123].

2.13.4 There is a separate list of entities at paragraph 6.124 of the old 2001 Stamp Office Manual[124]. HMRC regard these entities as "bodies corporate" for the purposes of stamp duty group relief (see 5.5.3) under Section 42 Finance Act 1930. "Body corporate" status of transferor and transferee (and of certain related parties) is a pre-requisite for such relief. The list contains entities which are also regarded as "opaque" on the list at INTM180030, such as the German Kommanditgesellschaft auf Aktien ("KGaA") and the US limited liability company ("LLC"). Interestingly, the entry on the Stamp Office list for Saudi Arabia states that "A company organised pursuant to the laws of the Kingdom of Saudi Arabia has been accepted although it did not have perpetual succession"[125]. No further explanation is provided.

Although not included in this list, HMRC have been known to treat a Delaware limited partnership as a “body corporate”, and hence the parent company of a group, for stamp duty group relief purposes. This author does not regard a Delaware limited partnership as a body corporate even if it has legal personality and even though a change in its membership does not lead to the entity being dissolved. In particular, the members’ interests in a Delaware limited partnership (unlike those of shareholders) are insufficiently separate from the entity’s own underlying income, assets and business, even if those members (like partners in a Scottish partnership) lack a proprietary interest in the entity’s underlying assets. The author similarly disagrees with those who have argued that a Delaware limited partnership is a “body corporate” for UK regulatory purposes (e.g. when applying the definition of an “open-ended investment company” in Section 236 Financial Services and Markets Act 2000).

2.14 Anson v IRC

2.14.1 The relevance of these lists now needs to be reconsidered in the light of the *Anson* litigation. This is the most significant UK tax litigation to date on questions of entity classification and tax-transparency. It is also the first such case to reach the Supreme Court. It leaves a number of important questions unanswered.

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[122] [1999] STC 531.

[123] Apparently, the UK tax authorities argued that, if there was to be a “partnership” for UK tax purposes (i) putative partners must have joint and several liability for the entity’s business debts; (ii) there must be multiple principals acting for the entity; and (iii) a putative partner must have an interest in both the assets and the profits of the entity. This thinking clings too closely to the English common law paradigm as does the UK tax authorities’ response to the Law Commission. The latter’s 2003 Report op.cit. indicates, at paragraph 6.7, that their proposal (that all UK partnerships should have separate legal personality) and that partners should simply be agents of this partnership entity was criticised by the UK tax authorities on the grounds that the mutual agency of partners was the pre-condition for a partnership being transparent for direct tax purposes.

[124] Which has not been updated for some years.

[125] This suggests that HMRC do not regard as “perpetual succession” as an inevitable feature of a “body corporate”.

The case involved an investment by Mr Anson, a UK-resident but non-UK-domiciled individual, in a Delaware limited liability company ("LLC") called Harbourvest, which carried on investment management business in the USA, and in Massachusetts in particular.

The LLC did not elect (see 7) to be treated as a corporation for US Federal and state tax purposes. By default it was therefore classified as a partnership for US tax purposes and therefore not itself subject to US Federal or state income taxation. Instead its members were taxable at Federal and state level on income of the LLC allocated to them in accordance with a profit-sharing mechanism set out in the 1997 LLC Operating Agreement. In short, they were taxed as partners on allocated income, whether or not distributed.

Because Mr Anson was non-UK-domiciled and hence able to claim the "remittance basis" of UK income taxation, there was no question of the UK taxing his share of LLC income unless and until he "remitted" it to the UK. However, that is what he did. US tax on his allocated share of LLC income had been levied at an effective rate of 45%. He claimed that he was entitled to credit this in full against his UK tax liability of 40% on the remitted income. There would therefore be no further UK tax to pay.

Credit for Federal income tax was claimed under the 1975 and (for later years) 2001 UK-US double tax treaties, as given effect in UK domestic law by Section 788 ICTA 1988[126]. Credit for state income tax was not available under the double tax treaties but was claimed as "unilateral relief" under Section 790 ICTA 1988[127].

However, HMRC rejected all claims for credit on the basis that the sums remitted by Mr Anson were not the same income on which he had been taxed in the US. They were effectively dividends from a tax-opaque LLC and hence a taxable income “source” distinct from the underlying US profits of the LLC. An individual receiving such a dividend was not entitled to any UK credit for the non-UK tax on the foreign profit pool which funded that dividend. HMRC's position was consistent with their long-held view (see 2.13) that a LLC was "opaque" for the purposes of taxing UK investors in such an entity[128]. The effect of HMRC's position was to create a substantial UK tax liability. On allocated US profits of 100, Mr Anson was liable for 45 of US Federal and state tax, leaving a post-tax amount of 55 to remit to the UK. At then prevailing UK rates, that sum was taxable at 40%. Without a UK foreign tax credit, there would be a further 22 of UK tax to pay in addition to the 45 of US tax[129].

Mr Anson appealed the denial of a foreign tax credit to the First-Tier Tribunal on several grounds. The only relevant ground of appeal for present purposes was that a foreign tax credit was available because the LLC was in effect "transparent". For reasons of taxpayer anonymity, the case before the First-Tier Tribunal was reported as *Swift v HMRC*[130].

2.14.2 The First-Tier Tribunal

[126] See now Sections 1-6 TIOPA.
[127] See now Sections 8-9 TIOPA..
[128] By contrast, HMRC regard a Delaware limited liability partnership ("LLP") as "transparent" for such purposes. Presumably it was for this reason that Harbourvest subsequently converted into a Delaware LLP. The substantive differences between a Delaware LLC and a Delaware LLP are minimal: see 7.2.4.2. Hence both can be used largely interchangeably in the US.
[129] Ignoring Dollar: Sterling rate movements and possible timing differences.
[130] [2010] UKFTT 88.

Detailed expert evidence of Delaware law was provided by both Mr Anson and HMRC. The tribunal considered this and also the detailed terms of the 1997 LLC Operating Agreement. The experts were asked a series of questions based on the six-item HMRC list discussed at 2.13 above. As already mentioned, that list makes no mention of whether members of an entity enjoy limited liability, whether they can freely transfer their interests or whether that entity exhibits “perpetual succession”.

The Tribunal made the following findings of fact:

(i) The LLC was a legal entity brought into existence by executing a certificate of formation with the Delaware Secretary of State and entering into a LLC agreement (in this case, the 1997 LLC Operating Agreement). That agreement was between the LLC members only: the entity was not a party to it.

(ii) The LLC itself carried on its business and the business assets belonged beneficially to the LLC and not to its members. They (under the Delaware Limited Liability Company Act -"the Delaware Act") had no interest in specific property of the LLC. Nor were they liable for the LLC's business debts for which it alone was liable[131].

(iii) In the case of this particular LLC, "the membership interest....is not similar to share capital but something more similar to partnership capital of an English partnership, the transfer of which requires the consent of all the partners but the economic benefits can be transferred without consent and without the transferee becoming a partner (s. 31 of the Partnership Act 1890). Normally a share in a UK company is transferable and needs to be registered and if there are restrictions on transfer these are that the consent of the directors (not all the other shareholders) is required."

(iv) Crucially, members of this LLC had an interest in the profits of the LLC as they arose. The profits of the LLC did not "belong to the LLC in the first instance and then become the property of the members because there is no mechanism for any such change in ownership, analogous to the declaration of a dividend. It is true......that the assets representing those profits do belong to the LLC until the distribution is actually made but we do not consider that this means that the profits do not belong to the members: presumably the same is true for a Scots partnership. **Conceptually, profits and assets are different** [emphasis added] ....s18-503 of the [Delaware] Act.... does not contemplate that profits can belong to the LLC as they must always be allocated to the members".

The tribunal further considered Article IV of the LLC Operating Agreement which set out the allocation mechanism. In particular each LLC member had a capital account to which capital contributions and income and expense allocations were credited and from which distributions were deducted. Allocations were to be made in conformity with Subchapter K of the US Internal Revenue Code. Each year's book income and expense was to be allocated to members' capital accounts. After making tax adjustments, Mr Anson's share of that net annual allocated amount was income for US Federal and state tax purposes.

[131] Hence the position of LLC members differed from that of Scottish partners or indeed members of a French SNC.

Article V of the LLC Operating Agreement was regarded as providing for mandatory distribution of any excess on capital accounts within 75 days of the end of each calendar year, subject to cash being available and the need to create reserves or withhold amounts in respect of US tax. Given the effect of Article IV allocations in creating member income entitlements, Article V had little direct relevance.

One area which the Tribunal did not address was whether the LLC had "perpetual succession" or "continuity of life". In particular, it did not consider Section 18-801 (Dissolution) of the Delaware Act. Whether the LLC had "perpetual succession" seemed to depend on the detailed provisions of the LLC Operating Agreement covering dissolution, taken in conjunction with Section 18-801. No evidence was produced in this regard[132].

The Tribunal then turned to the legal issues. In the 1975 UK-US double tax treaty[133], the key provision was Article 23(2)(a), which for present purposes read:

> "(2) Subject to the provisions of the law of the United Kingdom regarding the allowance as a credit against United Kingdom tax of tax payable in a territory outside the United Kingdom (as it may be amended from time to time without changing the general principle hereof) -
>
> (a) United States tax payable under the laws of the United States and in accordance with the present Convention, whether directly or by deduction, on profits or income from sources within the United States (excluding in the case of a dividend, tax payable in respect of the profits out of which the dividend is paid) **shall be allowed as a credit against any United Kingdom tax computed by reference to the same profits or income by reference to which the United States tax is computed** [emphasis added]."

Article 24(4) of the 2001 treaty[134] was worded very similarly. As for unilateral relief, Section 790(4) ICTA 1988 provided:

> "Credit for tax paid under the law of the territory outside the United Kingdom and computed by reference to income arising or any chargeable gain accruing in that territory **shall be allowed against any United Kingdom income tax or corporation tax computed by reference to that income or gain** [emphasis added]."

The key issue was therefore whether Mr Anson's UK tax was "computed by reference to the same profits or income" by reference to which US tax was computed, or whether he was only taxable in the UK on the equivalent of a dividend. The Tribunal ruled for Mr Anson as follows:

> "[This LLC] stands somewhere between a Scots partnership and a UK company, having the partnership characteristics of the members being entitled to profits as they arise and owning an interest comparable to that of a partnership interest, and the corporate characteristics of carrying on its own business without liability on the members and there being some separation between Managing Members and other members falling short of the distinction between members and

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132 For a fuller discussion of this point, see Gerald Montagu: "*Anson* and Entity Classification Revisited in Light of Brexit: can an LLC Constitute a "Body Corporate?" [2016] BTR 466 at 478-487.
133 SI 1980/568.
134 SI 2002/2848

directors. Since we have to put it on one side of that dividing line, **we consider that it is on the partnership side particularly in relation to its income** [emphasis added]"

"The factor we are mainly concerned with.....is whether the profits belong to the members as they arise. We have concluded that this is the effect of the LLC Operating Agreement and the [Delaware] Act. Accordingly [Mr Anson] is taxed on the same income in both countries and is entitled to double taxation relief...."

Of considerable interest is the comment which more or less states that the LLC in question is a type of partnership. This should be contrasted with *Dreyfus*[135]. In that case (which was not cited in *Anson*) the SNC was in some respects closer than the LLC to the partnership paradigm, not least because its members were directly liable to creditors for its debts. Yet the Court of Appeal ruled that it was not a partnership for UK tax purposes. A key factor in reaching that conclusion was the finding in *Dreyfus* that SNC members were **not** entitled to its profits as they arose[136].

As mentioned above, the First-Tier Tribunal never addressed the question whether the LLC had perpetual succession. It has been argued that, if this LLC had perpetual succession, then the decision should have gone against the taxpayer because the LLC would have been properly characterised as a company[137]. It is far from clear that this factor should be decisive: the multiplicity of forms which "partnerships" can take; the different legal cultures in which they originate; and the practicalities of operating partnerships over time as a single business entity[138], may well mean that such entities can exhibit perpetual succession, or something approaching it. This should not per se lead to them being characterised as companies if, in particular, members are in fact entitled to underlying profits as they arise[139].

Even under English partnership law, limited partnerships may exhibit a degree of perpetual succession. Section 6(2) of the Limited Partnerships Act 1907 provides that "a limited partnership shall not be dissolved by the death or bankruptcy of a limited partner, and the lunacy of a limited partner shall not be a ground for dissolution of the partnership by the court unless the lunatic's share cannot be otherwise ascertained or realised".

In paragraph 316 of the Law Commission op. cit., changes to English law were recommended such that English law partnerships would also be legal entities and would not (even in theory) dissolve

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[135] 14 TC 560.

[136] This is of course the finding with which the UK tax authorities now disagree because they regard it as based on faulty expert evidence. Hence, they now regard a SNC as "transparent" for UK tax purposes, and indeed as "analogous to a partnership": see 2.10.5.

[137] See Gerald Montagu; "*Anson* and Entity Classification Revisited in Light of Brexit: can an LLC Constitute a 'Body Corporate'"? op. cit.

[138] It is hard to imagine a large professional partnership being structured so that a change in membership, or the bankruptcy of a member, triggers a dissolution of the partnership. Even if it does so technically, this is most unlikely to have any enduring commercial significance: clients will deal, and intend to deal without interruption, with the partnership as it exists from time to time.

[139] Under the old pre-1997 US Federal entity classification rules, "continuity of life" (i.e. perpetual succession) was only one of four equally- weighted key corporate characteristics under the old "four-factor" test. It alone was never conclusive when deciding whether an entity was a partnership or a corporation for US tax purposes. For further discussion, see 7.2.6.1 below.

automatically on a change of partners. There was no suggestion that such changes would make a partnership a body corporate.

Finally, it appears that a French SNC often exhibits "perpetual succession", even though HMRC now regard it as "transparent" for UK tax purposes[140]. Why should an LLC be treated differently, especially now that so many UK "partnerships" are in fact UK LLPs which undoubtedly exhibit "perpetual succession", because they are corporate bodies (although enjoying a special UK tax status)?

2.14.3 The Upper Tribunal

HMRC appealed to the Upper Tribunal where Mann J. found against the taxpayer[141]. In particular, he ruled that the First-Tier Tribunal had incorrectly determined that Mr Anson had a proprietary entitlement to the LLC profits. It was therefore open to him to reconsider the case afresh. He went on to rule that the LLC was not transparent and its members had no meaningful interest in its profits.

The judge made the following comments in particular:

> "Like Robert Walker J [in *Memec*], a proprietary right in the underlying assets seems to me to be a crucial factor in the inquiry, and Mr Anson had none. I find it difficult to envisage any case of transparency where there is no such right, but whether or not that is possible, the absence in this case is fatal to the taxpayer's case. LLC owns everything. ......The interest of the members is not comparable to the interests of Scottish partners because they do not have an interest in the assets of the LLC. They certainly do not have a direct interest (statute provides that) and in my view there is no case for saying they have an indirect interest either, in the sense in which Peter Gibson LJ [in *Memec*] held that Scottish partners have such an interest in the assets of their partnership."

2.14.4 The Court of Appeal

Another appeal followed to the Court of Appeal which upheld the Upper Tribunal and ruled in favour of HMRC. The sole reasoned judgment was given by Arden LJ (as she then was)[142].

At the outset she made the following comment: "I propose to use the term 'tax transparent', in relation to UK tax, to describe the income of a member of an entity which is to be regarded as having the same source for the purposes of UK tax law as that of the entity from which it is derived. For this purpose, an entity includes a partnership or a trust which does not have a separate legal personality."

She then ruled that *Memec* was authority for the following proposition: where the taxpayer becomes entitled to the profit of an entity because of some contractual arrangement to which he is a party, he must show that the contract is actually the source of the profit, rather than a mechanism to secure a right to a profit derived from another source, if he is to establish tax transparency. This will in general mean that he has to show a proprietary right to the underlying profits. It was accepted, as in the courts below, that the profits of an English partnership are the profits of its partners as the business is

[140] See Gerald Montagu: "*Anson* and Entity Classification Revisited in Light of Brexit: can an LLC Constitute a 'Body Corporate'"? op. cit. at fn 80.
[141] [2011] STC 2126.
[142] [2013] EWCA Civ 63.

carried on by the partners as principals and agents for each other[143]. Arden LJ then made a number of further comments about the general need for a taxpayer to show a proprietary interest in order to demonstrate an entitlement to underlying profits of the entity as they arise[144]:

> "For these reasons, in order for a member of an entity to show that he was entitled to profits from the moment that the profit arose he will have to show that he has an interest in the assets to the value of the profit. This will necessarily be a proprietary interest.
>
> A partner in an English partnership has an equitable interest in the partnership assets and thus he will be able to show that he has a proprietary interest to the extent of his profit and share in the partnership.
>
> Likewise an income beneficiary under an interest in possession trust will be able to show an equitable interest in the income in question.
>
> [Counsel for HMRC] submits that it is impossible for the profits of a business to belong to a person other than the person carrying on the business. I agree that it is difficult to think of examples where this would be the case, save perhaps in one case. That is the case of an agency company.....But even in that example, the agency company may be little more than a nominee.
>
> In my judgment, it would be unusual but not impossible for an entity with a separate legal personality, such as a company, to be tax transparent for English law purposes. One example would be the Scottish partnership where the partnership is a separate legal entity and holds the assets of the business in common: this has been held by this court to be tax transparent and [Counsel for HMRC] assured the court that nothing in his submissions was intended to undermine that position."

The Court then agreed[145] with the Upper Tribunal that the First-Tier Tribunal had ruled erroneously that Harbourvest's profits belonged to its members in a proprietary sense. In fact they belonged to Harbourvest and the members' right to have profits allocated to their capital accounts represented a transfer of an entitlement to the profits, after Harbourvest had taken the sums which it needed (e.g. to create reserves or fund US withholding tax payments). Harbourvest was not analogous to a partnership: it had separate legal personality and unqualified ownership of its assets. Its members had no interest in those assets. The Court clearly did not accept the distinction drawn by the First-Tier Tribunal between an entitlement to profits (which need not be proprietary) and an entitlement to assets (which would necessarily be proprietary).

The automatic allocation provisions in the LLC Operating Agreement merely avoided the need for a managing members' resolution before making an allocation of profit[146].

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[143] Per Fox LJ in *Padmore v IRC* 62 TC 352.

[144] [2013] EWCA Civ 63 at paras 59-63.

[145] [2013] EWCA Civ 63 at paras 83-86.

[146] The Court also declined to hear late taxpayer submissions regarding the 2001 UK-US double tax treaty and based on an Exchange of Notes between the UK and the USA dated 24 July 2001. The Court queried whether this Exchange altered the precondition that the same profits must be taxable in both

2.14.5 The Supreme Court

Leave to appeal to the Supreme Court was granted and judgment given in favour of the taxpayer in early July 2015. There was a single reasoned judgment given by Lord Reed[147]. The Supreme Court had convened a second hearing in spring 2015 which in particular considered the nature of a Scottish partnership, with submissions from Scottish counsel.

Lord Reed noted the findings of the First-Tier Tribunal regarding the operation of Articles IV and V of the LLC Operating Agreement.

He noted that Mr Justice Mann had stressed the need for LLC members to have a proprietary right in its underlying assets in order to claim a UK foreign tax credit, because otherwise, they lacked an entitlement to the LLC's profits.

He then offered some support to the analogy drawn by the First-Tier Tribunal between the interest of a LLC member and that of a partner in a Scottish partnership. In particular he said[148]:

> "[The First-Tier Tribunal] ...based its conclusion that 'the profits belong as they arise to the members' not upon a confusion between profits and assets but upon the expert evidence as to the combined effect under Delaware law of sections 18-101(8) and 18-503 of the [Delaware] Act, which respectively defined a member's interest in an LLC as his share of profits and losses, and required the profits and losses to be allocated among the members in the manner provided in the LLC agreement, and article IV of the LLC agreement itself.....**The natural reading of the [First-Tier Tribunal's] decision, in those circumstances, is that when it described the profits as belonging to the members it was referring to a right in personam rather than a right in rem** [emphasis added].
>
> It would also be consistent with the comparison which the [First-Tier Tribunal] made between the LLC and a Scottish partnership. Although taxed in the same way as an English partnership....and having many points of similarity to an English partnership, a Scottish partnership differs in possessing separate legal personality. The partners do not, therefore, have any direct proprietary interest in any of the partnership assets (unless they happen to hold assets as trustees for the partnership). ....What the partners do own is a share of the partnership. That share is an incorporeal moveable right. .....Those rights are broadly analogous to those of a member of the LLC under the [Delaware] Act, as found by the [First-Tier Tribunal]. .....There are, of course, also some differences: in particular, the partners in a Scottish partnership, other than a limited partnership, have an unlimited liability for its debts, whereas the members of the LLC had no liability for its debts beyond their initial capital contributions, prior to their repayment. **Nevertheless, given the points of similarity, the comparison made by the [First-Tier Tribunal] between the LLC and a Scottish partnership was understandable, and did not carry the implication**

the UK and the USA in order to trigger a UK foreign tax credit. This aspect of the decision is discussed further in 6.4.3.

[147] [2015] STC 1777.

[148] At para 38 of his judgment.

[of a member's proprietary interest in partnership assets] which Mann J supposed [emphasis added]."

Lord Reed also queried the approach of the Court of Appeal. In particular, it was not clear that it had in fact followed *Memec* when it focussed on whether the taxpayer had a proprietary right to the profits of Harbourvest as they arose[149]. By contrast, in *Memec* itself[150] the Court of Appeal "adopted ....an approach[151] to 'transparency' which involved analysing the characteristics of the partnership agreement under the governing foreign law, comparing those characteristics with the characteristics of paradigm examples of arrangements which were transparent (such as English and Scottish partnerships) or opaque (such as UK companies), and determining whether in the light of that comparison.....the foreign partnership was relevantly similar to the transparent or opaque UK entities. That was the approach followed by the [First-Tier Tribunal] in the present case."

Overall Lord Reed expressed concern that the Court of Appeal's approach (unlike the First-Tier Tribunal) continued to confuse profits with assets. It also did not address the key foreign tax credit question whether the income taxed in one country was the same as the income taxed in another.[152]

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[149] An old House of Lords case not discussed in *Anson,* although mentioned in argument before the Supreme Court by counsel for the taxpayer, is *Drummond v Collins* 8 TC 525. That case supports the analysis of both the First-Tier Tribunal and the Supreme Court. In *Drummond,* on the facts as they had turned out, minor children were merely discretionary income beneficiaries of a US trust and their guardian received sums from the trustees on their behalf for their education and maintenance. All the courts ruled that these payments were income which was UK-taxable because its source was a “foreign possession” (the US trust fund) and it had been remitted to the guardian in the UK. The House of Lords (in particular Lord Parker at pages 539-540 and Lord Wrenbury at page 541) made clear that income could be “sourced” from a “foreign possession”, and taxable as such, even though the taxpayer (the guardian) did not have a proprietary right to the “foreign possession” because the children were discretionary beneficiaries. As Lord Wrenbury put it at page 541: “It is, however, contended that the case is not within [Schedule D Case V] for that this is not a foreign possession. This argument….is that property e.g. income derived from assets in another country, is not a foreign possession unless the person taxed owns the corpus of the foreign possession. If this were true no life tenant or other person having a limited interest in property abroad would be assessable under [Schedule D Case V]. The test is not, I think, whether there is an absolute interest in a foreign possession, but whether there is such an interest in a foreign possession that the party assessed derives income from it [emphasis added]….The income is annual profits arising to a person residing in the United Kingdom from property situate elsewhere than in the United Kingdom.”

[150] [1998] STC 754.

[151] See para 45 of Lord Reed’s judgment.

[152] During the Supreme Court hearing, Mr Anson advanced his earlier argument that, in the light of the findings of fact of the First-Tier Tribunal and as a matter of UK tax law, he was liable to UK tax on his allocated share of the LLC's underlying trading profits, which was the same income that had been taxed in the USA. However, he also put forward a new argument: even if US tax was charged on the profits of Harbourvest but he was only liable to UK tax on distributions from those profits, nevertheless UK and US tax were in fact charged on "the same profits or income" for the purposes of the 1975 and 2001 double tax treaties. In short, the taxpayer was asking for a looser, less semantic interpretation of the words "the same profits or income", based on accepted purposive norms for interpreting double tax treaties rather than the more narrowly linguistic approach of UK domestic tax law. The Supreme Court dismissed this argument after considering the genesis of Article 23(2) of the 1975 UK-US double tax treaty. In particular, the taxpayer could not derive any comfort from the fact that Article 23(2)(a), not (b), contained the words "(excluding in the case of a dividend, tax payable in respect of the profits out of which the dividend is paid)". This new argument of the taxpayer had no direct bearing on the tax transparency of Harbourvest and is not considered further.

Lord Reed finally addressed the taxpayer's argument that, based on the evidence of Delaware law, the same profits were being taxed in both the UK and the USA. *Memec*[153] was referred to although there was no detailed critique of that case. Rather it was noted that the question in Memec was: did the presence of the "silent partnership" mean that the UK taxpayer could be treated as receiving a share of the dividends paid by the German subsidiaries to the German subholding company? If so, a UK foreign tax credit would be available for underlying trade tax on the profits of the German subsidiaries which were used to fund those dividends. This was a different question from the one in *Anson* about whether the same profits directly earned from the LLC's activities were being directly taxed both in the UK and the USA.

Lord Reed concluded that Mr Anson's UK tax liability was indeed being computed by reference to the same income as was taxed in the USA. He was therefore entitled to a UK foreign tax credit for the US tax liability, both at Federal and state level. In reaching this conclusion, Lord Reed stressed[154] that:

> "....the rights of a member of the LLC were found to arise from the [Delaware] Act, combined with the LLC Agreement. ....that agreement was not a contract between the LLC and its members: the LLC was not a party to it, but was brought into being by it, on the terms set out in it and in the provisions of the [Delaware] Act. It was thus the constitutive document of the LLC. It was against that background that the [First-Tier Tribunal] made findings which contradict the premise that the profits belong to the LLC in the first instance and are then transferred by it to the members. Their conclusion, on the contrary, was that, under the law of Delaware, the members automatically became entitled to their share of the profits generated by the business carried on by the LLC as they arose prior to, and independently of, any subsequent distribution."

Those findings were findings of fact because they were findings, based on expert evidence, as to the correct non-UK legal position. They were fully justified by the evidence of Delaware law. Furthermore, the First-Tier Tribunal had not made the error of concluding that the LLC members' profit entitlement was a proprietary right. Hence its findings in favour of the taxpayer were not open to challenge and a full UK foreign tax credit was available.

2.14.6 HMRC response to Anson

The HMRC response to the Supreme Court decision in *Anson* has been guarded, although it is believed that HMRC have major reservations about the accuracy of the findings in the First-Tier Tribunal about the nature of a member's interest in a Delaware LLC. HMRC's main published statement on *Anson* was on 25 September 2015, in Revenue and Customs Brief 15 (2015). The key comments were as follows:

> "Lord Reed delivered the unanimous judgment of the court and he made clear that he relied on the facts found by the FTT, in particular those regarding the rights of Mr Anson that arose from the Delaware LLC Act and LLC agreement.
>
> The FTT made findings that the profits of the LLC did not belong to the LLC in the first instance but the members became automatically entitled to their share of the profits as the profits arose and

[153] [1998] STC 754.
[154] See para 119 of the judgment.

before any distribution. The FTT also found that the interest of a member in the LLC was not similar to share capital.

HMRC has after careful consideration concluded that the decision is specific to the facts found in the case. This means that where US LLCs have been treated as companies within a group structure HMRC will continue to treat the US LLCs as companies, and where a US LLC has itself been treated as carrying on a trade or business, HMRC will continue to treat the LLC as carrying on a trade or business.

HMRC also proposes to continue its existing approach to determining whether a US LLC should be regarded as issuing share capital. Individuals claiming double tax relief and relying on the *Anson v HMRC* decision will be considered on a case by case basis."

Apparently, HMRC have considered whether legislation should make clear that a LLC is always opaque for UK tax purposes. In any case, they correctly note that, like any other non-UK entity classification case, *Anson* turned heavily on findings of fact regarding the relevant non-UK law. As discussed further in 7.2.4.2, US LLCs are a very flexible vehicle and so much will turn on the governing agreement of a particular LLC, together with the limited liability company law of the relevant state in which it is formed. Almost all US states now have such a law and there is considerable convergence in their content.

It cannot therefore be said that, on the basis of *Anson*, all LLCs can be regarded as "transparent" for the purposes of taxing their income in the UK. LLCs have been extensively used in cross-border corporate group structures (e.g. “tower” group financing structures) on the basis that they are companies and that their members’ interests are “ordinary share capital” for UK tax purposes. HMRC are clearly not minded to disturb such arrangements. Taxpayers may not want simply to rely on the 25 September 2015 statement, which is insufficiently case-specific to be clearly legally binding on HMRC. A review and possible amendment of the relevant LLC documentation will be needed to ensure that, under the law of the relevant state, LLC members do not have an entitlement to profits as they arise but only have an entitlement to distributions as and when the LLC chooses to distribute[155].

The last point is linked to another key issue. If a LLC is to be respected as a company within a tax group for UK tax purposes, members' interests will need to be treated as "ordinary share capital" for UK tax purposes. Again, a well-advised taxpayer will want to look carefully at the structure of members' interests in the relevant LLC, bearing in mind the finding in *Anson* that the members' interests in Harbourvest were not akin to share capital.

[155] Getting to this position is likely to require removal of any language in the LLC Agreement that creates capital accounts for members and automatically allocates income and expense to them. Instead, the LLC Agreement should provide for members’ interests to take a form akin to paid-in share capital and for it to be clear that the entitlement to underlying profits lies with the LLC itself. Advice from local counsel will be needed to confirm that such modifications are fully effective under the relevant local law, and especially its LLC statute. US tax advice will also be required if the LLC is being taxed as a partnership in the United States, not least because the capital account provisions in the LLC Agreement are likely to stem from the requirements of Subchapter K of the Internal Revenue Code.

In Revenue & Customs Brief 87/09[156], HMRC set out guidance (now archived) on when a member's interest in a company amounts to "ordinary share capital" for UK tax purposes.

The following HMRC comments related to Delaware LLCs:

> "Section 18-702c of the Delaware Limited Liability Act provides that: 'Unless otherwise provided in a limited liability company agreement, a member's interest in a limited liability company may be evidenced by a certificate of limited liability company interest issued by the limited liability company.'
>
> If a DLLC issues 'shares' in this way and other factors relating to the company suggest that it has share capital [emphasis added] then we will accept that these 'shares' may be regarded as 'ordinary share capital' ....
>
> It should be noted that not all DLLCs issue share certificates but they may still have 'ordinary share capital'. Regard must be had to the particular terms of the agreement by which the LLC has been created. .....
>
> Other States within the United States of America have comparable legislation to Delaware. Where it can be shown that a particular State has legislation analogous to the Delaware legislation with which we are familiar, HMRC would expect to be able to provide advice in line with that for DLLCs."

This guidance made clear that whether a Delaware LLC's member's interest amounts to "ordinary share capital" will depend very much on the nature of those interests under Delaware law. That point is simply reinforced by the findings of the First-Tier Tribunal in *Anson*. Issuing certificates of limited liability company interest may be a helpful indicator that LLC members' interests are "ordinary share capital" but is unlikely to be conclusive.

3. The law following *Anson*

3.1 In *Anson*, the most senior UK domestic court has for the first time since *Garland v Archer-Shee* (see 4.3.3.2) addressed a question of "tax transparency", and in relation to a non-UK entity with legal personality. More importantly, the Supreme Court decision shows a willingness to break away from a rather narrow common law perspective in addressing such questions, thereby echoing the approach of the Court of Appeal in *Ryall v DuBois*[157]. It is also consistent with the Court of Appeal decisions in *Oxnard v Rahn*[158] and (much earlier) *Von Hellfeld v Rechnitzer*[159], although none of these cases was cited. The UK corporation tax legislation applies to entities formed in other jurisdictions which are nevertheless UK-resident or which carry on a taxable UK trade (notably through a UK "permanent establishment") or which derive income from UK real estate. In deciding what non-UK entities are subject to UK corporation tax, one needs to bear in mind that the nature of a "body corporate" and a

[156] Later set out in Appendix 11 of the Capital Gains Manual (now archived). See now Company Taxation Manual CTM00511 (accessed 5 June 2020), which is more terse, simply stating that a LLC organised under the law of a US state may issue transferable interests akin to share capital but they may not be evidenced by a certificate of interest. The lack of a certificate does not prevent the members' interests being "ordinary share capital" "provided (as would be expected to be the case) that the interests are clearly defined and recognisable as equity (ownership) interests in the entity". See also the discussion of a "share" in 2.10.5.
[157] 16 TC 431.
[158] [1998] 3 All ER 19.
[159] [1914] 1 Ch 748.

"partnership", and the method of forming either entity, may differ in other jurisdictions compared to the UK.[160]

The underlying radicalism of *Anson* is therefore important, and some commentators have overlooked this. For example, the observation has been made that "Where an overseas entity has separate legal personality, as does an LLC, and under local law carries on the business itself, the starting point must be that it is not a partnership, as it is not the partners who are carrying on the business. And so it is a company. There is nothing in *Anson* to displace this view"[161]. While one can agree on the starting point, what follows is hard to square with what *Anson* decided and indeed with HMRC's revised position that the SNC in *Dreyfus* was "analogous to a partnership". It also fails to shed light on what is meant by the partners "carrying on the entity's business". This concept cannot, in relation to non-UK entities, be narrowly tied to the English law partnership paradigm of mutual agency: see 3.2.

3.2 "Transparency" was recognised in *Anson* for UK foreign tax credit purposes, even though the UK-resident taxpayer was a member of an entity, a Delaware LLC, which was a separate legal person created by a statutory registration process; owning its own assets beneficially; incurring rights and liabilities as such; and itself (not its members) carrying on its business and being liable for its debts. In short, an entity which, from a UK perspective, looks more like a "body corporate" than does a Scottish partnership. It is true that much turned on the evidential findings of Delaware law. Nevertheless, the decision shakes off the shackles of tying "transparency" questions exclusively to whether the taxpayer had a formal proprietary interest, recognised by English law, in the underlying income and assets of the entity concerned. This was the approach of the Upper Tribunal and the Court of Appeal in *Anson.* It was also the approach of the High Court in *Memec*.[162] Those courts were too wedded to the English law analysis of a partnership as an aggregation of members (the "partners") based on mutual agency[163] and the law of trusts. This analysis of a partnership is by no means universal in countries influenced by common law e.g. US states such as Delaware where partnerships routinely have legal personality. It is also at odds with the definition of a formal partnership in most civil law countries, not least because of key differences in the law of agency[164] and, perhaps, the lack of a concept of trusts with which to segregate partnership property from the personal assets of the partners. This judicial mindset also explains some of the problems encountered by the lower courts in *Anson* and the courts in *Memec* when analysing Scottish partnerships[165].

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[160] For further discussion of these issues, focussing on the nature of "partnership" in common law and civil law countries, see Avery Jones: Partnerships op. cit. [2002] British Tax Review 375. The authors conclude that, because of significant differences between the common law and civil law concepts of agency (and especially regarding when an undisclosed principal acting through an agent can be liable to a third party dealing with that agent), civil law partnerships have to be formed differently to achieve equivalent legal outcomes to the common law. Hence, in particular, the prevalence of partnership entities with legal personality such as the French SNC. For further discussion of these agency issues, see Zweigert & Koetz (translated by Tony Weir): An Introduction to Comparative Law (3rd edition), Clarendon Press, Oxford at pages 431-441.

[161] See Philip Harle and Rupert Shiers: "Analysis: Anson, transparency and Brief 15/2015". Tax Journal, Issue 1281 at 9 (16 October 2015).

[162] [1996] STC 1336.

[163] See Section 5 of the 1890 Act.

[164] See Avery Jones: Partnerships op. cit. [2002] BTR 375.

[165] There is a school of thought, for the purposes of the Financial Services and Markets Act 2000, that Scottish limited partnerships are a form of "company" because of their separate legal personality. Consequently such partnerships have been inserted into some transaction structures to obtain regulatory exemptions for intra-group advisory activities. One example of this appears to be item 10 in the Schedule to the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001 (SI 2001/1062), which states that

3.3 While the Supreme Court in *Anson* broke new ground, how much new ground is less clear. Much was made by the First-Tier Tribunal and the Supreme Court of the automatic allocation of income and expense of the LLC to its members under the LLC's governing agreement. This underpinned the members' contractual entitlement to profits as they arose. Hence it created a much closer relationship between members, and the LLC's underlying business operations, than that enjoyed by a shareholder in a company.

Such an automatic allocation feature may be absent in non-UK entities treated as partnerships under their governing non-UK law[166]. Does that prevent the UK regarding them as "transparent", especially in the light of *Drummond v Collins?*

When considering how much new ground was broken in *Anson*, it is also important to remember that the court limited itself to answering the narrower question whether the taxpayer was taxable in the UK on the "same income" which had borne tax in the US. If so, a UK foreign tax credit was available. The Supreme Court did not definitively comment on whether the LLC itself was a "partnership" for UK tax purposes, but seemed sympathetic to comments in the First-Tier Tribunal that on balance it was a form of partnership. The author considers that, had it been required to do so, the Supreme Court would have regarded the LLC in *Anson* as a form of "limited partnership" for UK tax purposes. The alternative would have been to treat the LLC as a "body corporate" which was nevertheless "transparent" for certain UK tax purposes. This would be highly unusual and would create a major mismatch with UK bodies corporate. A domestic body corporate would never be "transparent" for UK tax purposes absent very specific deeming rules to the contrary (e.g. those regarding a UK LLP and a EEIG)[167].

"Arrangements do not amount to a collective investment scheme [and hence do not require regulation] if each of the participants is a **body corporate** [emphasis added] in the same group as the operator". This school of thought misunderstands the nature of a Scottish partnership: Section 4(2) of the 1890 Act makes clear that a Scottish partnership has a separate legal personality but is still a partnership. As for the Financial Services and Markets Act 2000, it simply defines a "body corporate" in Section 417(1) as including a body corporate constituted under the law of a non-UK jurisdiction. A partnership does not appear to be included, not least because Section 417(1) contains a separate definition of "partnership" which simply includes a non-UK partnership.

[166] As already discussed, HMRC disagree with the expert evidence in *Dreyfus v IRC* 14 TC 560 that members of a French SNC are not entitled to profits as they arise. However, when it comes to **distributing** realised profits of a SNC, a decision must be made by a SNC to make a proper distribution: see Cass. Com. 14/12/2010 No 09-72.267 (No 1315 F-D) *Ste Bar tabac Le Laguiolais c/ Gambetta,* referred to in Avery Jones: "The English Dreyfus Case – categorisation of a French SNC for tax purposes in the UK" op. cit. This of course differs from an English or Scottish partnership where there is no restriction under the general law preventing a partnership paying out realised profits (although a prudent management will ensure that there is adequate cash to fund any distributions). In any case, a restriction on distributing profit is not the same as a restriction on an entitlement to profit, so there is no necessary conflict here with HMRC's revised position on *Dreyfus*. For other examples of civil law jurisdictions where an entity-level resolution may be needed to distribute profits, see Avery Jones: Partnerships op. cit. [2002] BTR 375 at 415.

[167] The UK rules implementing the 2009 EU Mergers Tax Directive (Directive 2009/133/EC) envisage that some companies (as defined by that Directive) can nevertheless be "transparent" for the limited purposes of the Directive, which (in particular, in Articles 4 and 8(3)) restricts tax relief where transactions involve "transparent" companies. Those restrictions do not, however, go as far as imposing a "pass-through" tax charge on the members of such a company in respect of its underlying income and gains. That is a matter left to each Member State. The Directive simply provides that a company is to be treated as "fiscally transparent" or otherwise "on the basis of [the relevant] Member State's assessment of the legal characteristics of that company arising from

Treating a LLC structured like Harbourvest as a form of limited partnership for UK tax purposes would in particular lead to a sensible outcome if that LLC carried on a trade through a UK "permanent establishment", as well as having UK-resident members. In that case, the UK trading income of the LLC would be taxable at the level of the members, as partners, together with any non-UK income of the LLC allocable to its UK members (and, where relevant, remitted to the UK). By contrast, if the LLC were treated as a body corporate (not a partnership) but at the same time "transparent" in relation to its UK-resident members, then the outcome would be quite odd[168]. In particular, there is no reason

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the law under which it is constituted". Similar words are used in Article 4(2) of the 2011 Parent-Subsidiary Directive (Directive 2011/96/EU). These "transparency" provisions have been reflected in UK law: see Sections 140E to 140L TCGA. This UK legislation defines a "transparent entity" as one which is resident in a Member State other than the UK; is listed as a company in the Annex to the 2009 Directive; lacks "ordinary share capital" (as defined in Section 1119 CTA 2010) and "if it were resident in the United Kingdom, would not be capable of being a company, within the meaning given by the Companies Act 2006": see Section 140L(1)(c) TCGA. It is not clear how Section 140L(1)(c) was derived from the definition of "transparent entity" in the 2009 Directive, which does not mention "ordinary share capital". Presumably the thinking was that only an entity which is truly a "body corporate" can issue a member's interest which the UK would recognise as "ordinary share capital". The last part of Section 140L(1)(c) then excludes from "transparent entity" status a non-UK entity which resembles a UK company limited by guarantee, which is of course a body corporate but does not have share capital. An example of a non-UK-resident "company" listed in the Annex to the Mergers Directive which is "transparent" on this basis is a Dutch "open" CV (see 7.3.2), which from a UK perspective is simply a contract between its members. Its ensuing lack of legal personality prevents it having "ordinary share capital" by UK standards and, if UK-resident, it could not become a company under the Companies Act 2006.

The Articles in the Mergers Directive dealing with "transparent entities" have been reflected rather differently in the UK domestic law on "loan relationships" (Part 5 CTA 2009); "derivative contracts" (Part 7 CTA 2009) and "intangible fixed assets" (Part 8 CTA 2009). In those Parts, the implementing legislation simply defines a "transparent entity" as "a company which is resident in a Member State other than the United Kingdom and does not have an ordinary share capital". For example, see Section 438(4) CTA 2009. This language lacks the equivalent of the last part of Section 140L(1)(c) TCGA, with the result that a non-UK equivalent of a UK company limited by guarantee is, confusingly, treated as "transparent" for these purposes. Overall, the 2009 Directive gives "transparent entity" a special meaning in UK tax law in order to limit certain EU law-based tax reliefs. This bespoke meaning, with its limited ambit, does not alter the general point that typically, a "body corporate" is an opaque entity for UK tax purposes, whether or not it has "ordinary share capital".

The EU Anti-Tax Avoidance Directive (2016/1164/EU as amended by 2017/952/EU)("ATAD") deals, in Articles 9 and 9a, with hybrid and reverse hybrid mismatches. However, it does not directly define a "fiscally transparent" entity. The closest it gets is a definition in Article 2(9)(i) of a "hybrid entity" as "any entity or arrangement that is regarded as a taxable entity under the laws of one jurisdiction and whose income or expenditure is treated as income or expenditure of one or more other persons under the laws of another jurisdiction". The second part of this definition describes fiscal transparency. There are some parallels with the definition of a "hybrid entity" in Section 259BE TIOPA, for the purposes of Part 6A TIOPA. Part 6A is the UK legislation tackling aspects of hybrid and other mismatches in response to the conclusions of BEPS Action 2. Section 259BE is discussed further in 5.2. It is not surprising that there are parallels between it and Article 2(9)(i) of ATAD, which gives effect in EU law to a number of the BEPS Action 2 recommendations.

[168] In Avery Jones: Partnerships op. cit. [2002] BTR 375 at 426-7, the learned authors suggest that entity classification mismatches may be minimised if a jurisdiction ("A") follows the classification adopted by the

why the LLC would not be subject to corporation tax in its own right, as a "company", on its UK trading income. Yet would that income also be automatically allocated to its members as per the LLC agreement and taxable in their hands, whether or not distributed? If so, how would this allocation be achieved if the special UK rules for taxing the income and gains of partnerships at partner level did not apply? Even if this allocation could be done, it would raise a major risk of double taxation for members. Corporation tax is a primary liability of the taxable entity. It is not a representative charge on behalf of the members of the entity. They would therefore have no right to set any corporation tax liability of the LLC against their own liability on the LLC's income. Furthermore, the corporation tax definition of "income" differs from that for income tax e.g. in relation to the taxation of debt, derivative contracts and intangible fixed assets. Hence, would tax be chargeable at both entity level (corporation tax) and member level (income tax) on different tax bases?[169].

3.4 While *Anson* marks a willingness to look beyond UK domestic law paradigms when addressing the classification of non-UK entities and tax transparency, and to focus on the legal system which gave birth to the entity, and the role of that entity within it, UK courts will wish to retain the last word. Otherwise the UK will have lost control of the shape and boundaries of its own tax system. Without a more sweeping reform imposing more prescriptive rules, the tax classification of non-UK entities will continue to involve asking detailed questions about the entity's structure compared to UK entities. Many of these questions may be meaningful and significant from a UK legal standpoint (e.g. is an entity member entitled to profits as they arise?; does the entity have legal personality?) but may well be rather less important from the standpoint of the relevant non-UK legal system, which may have a rather different approach to such questions.

Without significant reform, the tax classification of non-UK entities is therefore likely to remain an expensive, time-consuming and uncertain process for both taxpayers and HMRC, especially as it may now require a deeper understanding of the legal system which gave birth to the relevant entity. HMRC have limited resources to devote to this area[170] and entity classification questions will almost certainly involve obtaining evidence from experts on the relevant foreign law. Such experts may disagree on material issues. Furthermore, the key questions which the UK regards as important from its tax perspective may lack meaning, or have an entirely different meaning, from the standpoint of the non-UK legal system in question. For example, German and Swiss law consider that an entity can lack legal personality and yet have full legal capacity, whereas English law would see legal personality and full capacity as two sides of the same coin. These differences in meaning risk devaluing the answers provided by local law experts.

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entity's home jurisdiction when taxing residents of A who invest in that non-A entity. The classification approach of comparing a foreign entity with domestic entities would only apply where that foreign entity was being taxed by A at source. The authors' suggestion seems hard to operate where the entity in question has members resident in A and also has A-source income. In effect, A would be applying to the entity concurrently two entity classification approaches, with potentially very different consequences if A regarded the entity as opaque but the entity's home jurisdiction viewed it as "transparent". .

[169] It is therefore very doubtful whether *Anson* ushers in the concept of a "transparent body corporate" for UK tax purposes, although some commentators have suggested otherwise: see, for example, Charles Yorke: "Anson: entity classification revisited" Tax Journal 8 July 2015.

[170] HMRC are prepared to give rulings on transparency and entity classification issues but this is likely to be a slow process and will involve the taxpayer providing HMRC with all the necessary material (including evidence of relevant non-UK law) as well as the detailed supporting analysis.

3.5 An important aspect of *Anson* is that it increases the divide between how the UK classifies domestic and non-domestic entities for tax purposes. Entities formed under the domestic law of England and Wales, Scotland or Northern Ireland are usually classified prescriptively for tax purposes. Taxpayers have little or no scope to change that classification. In particular, companies incorporated in the UK (and, in particular, under Companies Act 2006) are taxable entities as such (leaving aside the special rules applying to UK LLPs and EEIGs, which in any case apply irrespective of how such an entity's constitution is drafted). There is no reason to believe that a UK private limited company, with articles of association mirroring the LLC agreement in *Anson*, could successfully claim that it was not subject to UK corporation tax or that its shareholders are subject to tax on the basis that they are entitled to a prorata share of the company's underlying profits as they arise. Were a court to accept such an argument, the UK corporation tax base could be severely eroded.

The UK entity classification position is of course more flexible and fact-sensitive regarding non-UK entities. The UK's "corporate resemblance" approach is less prescriptive, works by analogy from UK paradigms and is influenced by the precise UK tax rules which are being applied. The effect of *Anson* is to increase this flexibility. Indeed it gives a taxpayer greater control over whether an entity is "transparent" for UK tax purposes, provided that the entity's constitution is drafted appropriately and the relevant governing law gives legal effect to that drafting (as Delaware law apparently does). It is not obvious that this extra flexibility is a good thing because it places at an even greater advantage those taxpayers with the advisory resources and the sophistication to exploit it. This flexibility may also make it more attractive to conduct UK operations through a UK "permanent establishment" of an entity formed outside the UK, rather than to conduct them through a UK entity whose tax classification can be manipulated less easily.

There must in any case be limits to this flexible classification system even in relation to non-UK entities. Otherwise the UK will have lost control of the boundaries of its tax system. In particular, if the evidence shows that a non-UK entity is not just a separate legal person but has a legal status in the relevant jurisdiction equivalent to a "body corporate" in English law, then that entity should be regarded as a "body corporate" for UK tax purposes, even if its constitution purports to give its members rights to underlying entity profits as they arise. A good example of such entities would be those US entities whose names include the suffix "Inc." or "Corp". In these cases (unlike LLCs) there is a clear intention not just to create a separate legal person but to go further and create the very clear demarcation between the rights of the entity and the rights of its members which distinguishes a "body corporate"[171].

3.6 The more flexible post-*Anson* approach to the classification of non-UK entities could potentially raise issues under European Union law, which are discussed at 6.7.8.5.

3.7 In the wake of the *Memec* litigation, HMRC published the list discussed in 2.13. The limitations of that list have already been discussed but post-*Anson*, it needs to be treated with extra caution. In particular, it is not clear that Harbourvest would have been treated as "transparent" on the basis of the HMRC criteria. While HMRC accord particular significance to an entity's profits accruing to

[171] Delaware law, like the law of a number of other US states, provides for the creation of such incorporated entities as well as partnerships and LLCs. It differs from the historical position of English law by offering the LLC alternative which, as the First-Tier Tribunal noted in *Anson,* is a hybrid entity sitting somewhere between a classic general partnership and a "body corporate". The binary "body corporate" versus "partnership" approach of English law has been something of an outlier although now modified somewhat with the advent of UK LLPs.

members as they arise (as in *Anson*), Harbourvest LLC was also a separate legal person which owned assets, incurred liabilities and carried on business on its own behalf, not that of its members. Under the listed HMRC criteria, most factors therefore pointed towards non-transparency. Hence, the list seems too restrictive following *Anson*. At the very least, item (iv) in the HMRC list seems to have acquired even greater significance[172].

3.8 A final question arising from *Anson* is whether *Memec* [173]remains good law. The Supreme Court did not consider in detail and did not overrule *Memec,* in which a somewhat different question of "transparency" arose for UK foreign tax credit purposes.

In the High Court in *Memec*, the judge focussed heavily on the "silent partner" needing, but lacking a proprietary interest in the shares held by the "silent partnership" and in its dividend income, in order to establish transparency. That reasoning seems very similar to that of the Upper Tribunal and the Court of Appeal in *Anson* and hence suspect in the light of the Supreme Court decision: the lack of such a proprietary interest cannot be regarded as conclusive. Furthermore, despite the arguments which they advanced in both *Memec* and *Anson,* HMRC should be able to live with this, given their opinion of the decision in *Dreyfus:* members of a SNC do not have a proprietary interest in its assets and income.

In *Memec*, the Court of Appeal focussed less on proprietary interest and more on whether the "silent partner" was indeed carrying on a "business in common" with the other partner. The apparent lack of such a “business in common” precluded the transparency normally associated with a partnership. Hence no UK foreign tax credit was available. The Court of Appeal seems to have given little weight to the fact that the "silent partnership" structure is one mechanism whereby German law achieves an outcome very similar to a limited partnership registered under the Limited Partnerships Act 1907[174]. Such limited partnerships are common collective investment vehicles. The limited partners are typically passive investors (e.g. tax-exempt pension funds) which mainly provide subordinated debt to the partnership, the return on which is profit-linked. Hence, their position closely resembles a silent partner. Yet the classic UK limited partnership structure does not prevent there being a “business in common” between the limited and general partners, for the purposes of Section 1(1) of the 1890 Act. This is so even though the limited partner will necessarily play a very passive role and not engage in partnership management. .

Therefore, it is harder to accept in the wake of *Anson* that the Court of Appeal decision was correct. The silent partner's interest may be "just a contractual one" but then so is the interest of a limited partner in a Scottish limited partnership registered under the 1907 Act. The separate legal personality of such a partnership denies the limited partner a proprietary interest in the partnership assets, but it is still treated as a partner in the business, although barred from taking part in its management if its liability is to remain limited.

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172 Although HMRC are known to disagree with the decision in *Anson*.

173 [1996] STC 1336 and [1998] STC 754.

174 In order to avoid losing limited liability under the 1907 Act if and when a formal capital contribution is returned by the partnership, limited partners have typically structured most of their investment in a limited partnership as subordinated debt, not a formal capital contribution. That debt can then be repaid without prejudicing limited liability (although recent changes to the 1907 Act have reduced the need to use debt funding in this way).

Under German law, the "silent partner" can behave as a partner in relation to the other partner who carries on the business, by sharing profits and absorbing a share of any losses, without becoming directly liable to third parties for obligations of the partnership. This is because the identity of the silent partner is typically not disclosed to third parties. Furthermore, under the German law of agency, the other partner would have to act "in the name of" the silent partner when dealing with third parties in order to make the silent partner liable to them[175]. It would be unusual for the other partner to do that.

By contrast, the starting point for English law is that all partners are each other's agents when acting in the course of partnership business. Hence they can bind each other in relation to third parties. In particular, a partner who is an undisclosed principal can become liable to a third party dealing with the partnership, through the agency of another partner. Without the registration procedure under the 1907 Act which limits partner liability, an undisclosed limited partner would automatically have unlimited liability, via the general partner, to third parties who have dealings with the limited partnership. Registration ensures that the limited partner's liability to those third parties is limited, provided that it does not take part in the management of the partnership business[176]. Therefore, mechanically, English and German law limit the liability of a limited/silent partner in different ways, because of important differences in their underlying approach to the law of agency. In many ways, the German approach is neater and simpler. However, these non-tax differences should not obscure for tax purposes the very close similarities between the role of the "silent partner" on the one hand, and the limited partner on the other, especially if the limited partner has no proprietary interest in partnership assets because the limited partnership is formed under Scottish law.

In response, HMRC can point to Section 2(3)(d) of the 1890 Act which provides that "the advance of money by way of loan to a person engaged or about to engage in any business on a contract with that person that the lender shall receive a rate of interest varying with the profits, or shall receive a share of the profits arising from carrying on the business, does not of itself make the lender a partner with the person or persons carrying on the business or liable as such……"

An example of such a profit-related loan arrangement falling short of partnership is a so-called "theatre angel" i.e. someone who provides financial backing for a theatre production by way of a limited-recourse loan carrying a right to a share of any profit from the production. HMRC practice is to treat such arrangements simply as lending. The profit over and above any return of investment is taxed as an "annual payment"[177]. While this example is interesting, it is not conclusive when reviewing the facts of *Memec*, especially given the use of profit-linked loans to invest most of partner capital in an English limited partnership. Furthermore, as discussed in 2.12.2, German law distinguishes between a profit-linked loan and a "silent partnership".

[175] Civil law countries such as Germany apply the law of agency in a way which makes it much harder than under the common law for an undisclosed principal to become liable to third parties via an agent. A "silent partner" is a good example of such an undisclosed principal. For further discussion of the differences between the common law and the civil law of agency, see pages 431-441 of "An Introduction to Comparative Law" (3rd ed.) Zweigert and Koetz, translated by Tony Weir. Oxford.

[176] Section 6(1) of the 1907 Act.

[177] See Section 683 ITTOIA 2005. For further guidance, see page BIM66601 in the HMRC Business Income Manual (accessed 6 June 2020).

One may also query why some "theatre angel" arrangements are not treated as a form of partnership interest, as in *Pooley v Driver*[178]. However, if they were, registration under the 1907 Act would be needed to limit the liability of the "angel". This would be cumbersome at the very least and may explain why in practice, HMRC are willing to tackle the matter in a different way.

One final point regarding *Memec* is that apparently, the Court of Appeal judges emphasised that the silent partner only received its profit share, after the German company had taken a decision to pay out profits. In short, there was no automatic entitlement to be paid such profits. In the author's view, this seems little different from a standard limitation on the rights of partners in an English partnership to receive cash "drawings" on account of partnership profits. It should not detract from their underlying entitlement to a share of accruing profit. This is so even if that profit cannot be quantified until after the relevant period has ended and cannot immediately be paid out to them as cash. Furthermore, *Drummond v Collins*[179] provides authority that income received by a person does not necessarily lose its underlying "source" simply because of an intervening third-party decision to allocate and pay that income to that person. In *Drummond,* non-UK trustees of a non-UK trust exercised their discretion to pay underlying trust income to certain UK-resident beneficiaries.

Following *Anson,* the conclusion in *Memec* on the "transparency" question seems too restrictive. This still leaves a difficult borderline. If it is possible for a member of an entity to be taxed on the basis that the entity is "transparent" even though the member has no proprietary interest in its assets and income, where does one draw that line? The member's interest in the entity is merely contractual. Yet so is the interest of a shareholder in a company; of a lender to an entity under a profit-linked loan; or of a bank counterparty under a "total return swap". One would not regard these last three examples of contractual rights as entitling their holder to be taxed as if the relevant entity were "transparent". However, it is harder to pin down what (apart from semantics) differentiates these three purely contractual entitlements from those of a member of an entity (e.g. a French SNC or a Delaware LLC) who is taxable on the basis that the entity is "transparent". The lender or swap counterparty may well not be a subordinated creditor, which is important. That aside, does the answer to classification and "transparency" questions regarding non-UK entities depend largely on whether member entitlements have been drafted correctly?

3.9 The UK rules for classifying entities as "companies" or as "partnerships" are therefore a mixture of specific statutory rules regarding some entity types (e.g. UK LLPs, EEIGs and "unit trusts"), supplemented by judge-made rules in relation to other entities, especially non-UK entities, where a fact-driven "resemblance" test applies. Overall the judge-made rules leave much to be desired, not least because they are often uncertain and can be very cumbersome to operate in relation to non-UK entities.

Overall there is much less classification flexibility regarding entities formed under UK law, although (because of UK LLPs) a taxpayer can now choose a form of UK-incorporated business entity which is "transparent" for most tax purposes but which is little different from a private limited company. Is giving taxpayers such an easy choice good tax policy?

178 (1877) 5 Ch 458.

179 8 TC 525. *Drummond* was cited in the Court of Appeal in *Memec* but only mentioned in passing in the Court's judgment.

The courts have tried to limit the "unincorporated association" concept in order to minimise the risk of imposing corporation tax on unincorporated entities. In the author's view, this is a sensible, if rough-and–ready approach, but HMRC disagree.

Turning to non-UK entities, the courts, HMRC and taxpayers struggle, when pigeon-holing the wide variety of non-UK entities, with very different legal cultures and conceptual frameworks. Entities which are clearly and explicitly incorporated outside the UK can and should be classified as companies for UK tax purposes. However, many other types of entity cannot be classified so easily and have features placing them in an intermediate category between the rather binary English law concepts of a "body corporate" and a "partnership" lacking legal personality. UK law lacks a more elaborate spectrum of business entities (ignoring the rather special case of Scottish partnerships and the "transparent" body corporate known as the UK LLP). Hence it is no surprise that much of the limited tax litigation in this area has focussed on this intermediate category. It has so far not produced a coherent body of classification criteria, nor a clear order of priority in which to apply them. The list of criteria produced some twenty years ago by HMRC was problematic in the first place and is now looking out-of-date. In any case it has no binding force.

Anson has cleared some of the undergrowth but has left important questions unanswered, not least because the Supreme Court judges were clearly keen to confine themselves to those issues needed to resolve that case. At least *Anson* suggests that, when considering non-UK entities in particular, the main defining feature of a "partnership", as opposed to a "body corporate", is that members of the entity should be entitled to its underlying profits as they arise and that this can occur even if the partnership has what the UK would regard as legal personality. Such thinking is welcome although it probably gives too much scope to well-informed taxpayers to pick their preferred UK tax treatment for non-UK entities. *Anson* also widens the gulf between the UK's approach to classifying UK, versus non-UK entities, with the former being classified on a much more prescriptive basis than the latter. While this is not dissimilar to the Dutch approach (see 7.3), it is very different from the US approach see 7.2).

Yet clear and effective entity classification criteria, which do not give taxpayers too much scope to pick and choose their tax treatment, are essential to demarcate and protect the UK tax base, and especially the corporation tax base. In so doing, they determine those entities and arrangements which are not regarded as "companies" for tax purposes. Such entities or arrangements are potentially "transparent" (in particular, taxable only at the level of their members) for UK tax purposes. What "transparency" means will be explored in later chapters. In particular, it has specific connotations in relation to trusts. What trusts are and their transparency under UK tax law are discussed in 4 and 5.

4.1 Defining trusts and deciding when they are transparent for UK tax purposes

The trust is often regarded as a distinctive creation of the common law (and more particularly of the English courts of equity), although some civil law jurisdictions have to varying degrees adopted trust-like concepts[180]. Furthermore trusts have long been a very flexible tool for asset management and tax planning. The tax legislation has responded accordingly with extensive rules regarding the taxation of trusts themselves; of those who set them up or fund them in any way; and of those who have an interest in them. This chapter will discuss in particular the extent to which UK tax rules treat those interested in the trust as entitled to its underlying income and gains as they arise to the trustees (in short, treat it as "transparent"). The overall picture is far from simple and the outcomes far from satisfactory. There is much room for improvement.

4.1.1 Identifying trusts

It is important first of all to consider what should be treated as a trust for UK tax purposes. While the tax interface between companies and partnerships has attracted a lot of discussion and analysis, the same is less true of the interface between trusts and other entities (e.g. companies), even though the precise classification of the entity can have major tax repercussions for it and those interested in it. One such repercussion is Inheritance Tax. This undoubtedly applies to trusts (or, to be more precise, “settlements”, a concept which includes, but is not confined to trusts). However, it does not automatically apply to companies, although there are important exceptions for transactions involving “close companies”: see 5.3.

For the most part, a trust is not an entity or person at all under English law (unlike a body corporate or indeed a Scottish partnership). Rather it is a special relationship between the person providing the assets subject to the trust (the "settlor", of whom there may be more than one); the persons who derive benefit from those assets and income in one way or another (the "beneficiaries")[181]; and above all the person(s) who own the assets provided by the settlor but are obligated to administer them for the beneficiaries. The latter are the “trustee(s)”. Classically, the trustee is simply a pre-existing legal person acting in a particular capacity for the benefit of others. Setting up a trust therefore does not per se create a new legal entity[182] but does impose particular obligations on the trustee(s) and, in some cases, on third parties too. It is those obligations on third parties which in particular have enabled beneficial interests in trusts to be seen as a form of property right (at least in common law jurisdictions), although the proprietary nature of a beneficial interest in a trust is the subject of much debate[183]. Trustees may be natural persons or non-natural persons (typically, bodies corporate,

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[180] For example, France has created the concept of the “fiducie”. Quebec, whose property law derives from the French civil law tradition, based on Roman law, has gone a stage further and enacted in 1994 a fully-fledged law of trusts or “fiducie”: see Marilyn Piccini Roy in “Usufruct in Quebec”, Trusts & Trustees (2017) 24(1): 17. The trust is a recognised concept in both Scottish and South African law. Both these jurisdictions have “mixed” legal systems blending common law concepts with civil law concepts. In the case of Scottish law, the trust has been a feature since the seventeenth century and is a judge-made concept (unlike Quebec). In South Africa, the courts began to develop the concept of the trust in the nineteenth century.

[181] Of course, in some situations, a trust may be set up for the benefit of fulfilling a specified purpose (notably, charity) rather than with specified beneficiaries.

[182] In one limited sense, a trust always has an entity-like quality: if a trustee is replaced, substituting a new trustee is not regarded as reconstituting the trust. In short, once a trust has been set up initially, it is an enduring concept, even if the identity of the particular trustee(s) changes over time.

[183] See *Akers and others v Samba Financial Group* [2017] UKSC 6 at paragraph 35, where Lord Mance notes how courts in civil law jurisdictions (in particular, Scotland and Italy) have developed a separate concept of “patrimony” to explain, in particular, how property which English law would regard as held by a trustee can be

which are often purpose-formed for the role). Trustees are often professional trustees remunerated as such. Under English law, the settlor may declare itself the trustee[184].

The Recognition of Trusts Act 1987 gives effect in UK law to the Convention on the Law Applicable to Trusts and on their Recognition. Article 2 of that Convention[185] (which is scheduled to the 1987 Act) contains a useful description of a trust:

"A trust has the following characteristics:

(a) the assets constitute a separate fund and are not a part of the trustee's own estate;
(b) title to the trust assets stands in the name of the trustee or in the name of another person on behalf of the trustee;
(c) the trustee has the power and the duty, in respect of which he is accountable, to manage, employ or dispose of the assets in accordance with the terms of the trust and the special duties imposed upon him by law.

The reservation by the settlor of certain rights and powers, and the fact that the trustee may himself have rights as a beneficiary, are not necessarily[186] inconsistent with the existence of a trust."

This definition is deliberately designed to cover the trust concept as it exists in both common law and civil law jurisdictions. In particular, there is no reference to the common law concepts of "legal" and "equitable" ownership, which are alien to the trust concept as developed in civil law jurisdictions and in those with a "mixed" common law and civil law heritage.

In the recent Privy Council decision in *Investec Trust (Guernsey) Ltd and another v Glenalla Properties Ltd and others*[187] [2018] UKPC 7, [2018] 4 All ER 738, the Board discussed in some detail the nature of a trust under English law. The majority[188]reiterated that a trust is not a legal person and that a trustee assumes liabilities as such personally and without limit. Hence unless the trustee explicitly incurs obligations "as trustee only", a trustee's liabilities as such can be enforced against both trust and personal assets. However, a creditor has no direct access to the trust assets to enforce an obligation of the trustee, although the creditor can take a fixed charge over trust assets. The trustee has a right of indemnity for itself from the trust estate, enforceable by equitable lien. A creditor of the trustee can be subrogated to this right of indemnity, but that right may prove worthless (e.g. if the trustee is in breach of trust). The majority also alluded to the rather different approach of the law of trusts in the US, where the trust is increasingly regarded as a legal person, with the trustee acting as its agent. This relieves the trustee of personal liability for trust obligations, while giving creditors of the trust

protected from claims by a trustee's personal creditors. This "patrimony" concept is not perceived by those jurisdictions as a new kind of property right. For more on "patrimony", see fn 278.

[184] This may not always be possible under the "fiducie" concept, which may require a founding contract between the settlor and a separate trustee.

[185] As noted by Lord Sumption and Lord Collins in *Akers and others v Samba Financial Group* [2017] UKSC 6 (see in particular paragraphs 91-2 and 99-101), the main purpose of that Convention is to ensure that the main features of a trust are recognised by parties to the Convention (in particular, civil law jurisdictions) which would not otherwise recognise a trust. Currently, only 12 states are parties to the Convention (notably, Italy, Liechtenstein, Luxembourg, Monaco, San Marino and Switzerland).

[186] There may of course be cases where the reservation of powers by the settlor is so extensive that the alleged trust is an illusion: see fn 195.

[187] The case was not a tax case and ultimately focussed on the trust law of Guernsey and Jersey.

[188] At [2018] 4 All ER 738 at 756-760.

better recourse in the form of a direct claim against its assets. In his dissenting judgment, Lord Mance developed this last point,[189] noting the Delaware statutory trust which is discussed further below.

4.1.2 Trusts v companies/ foundations, etc

A trustee which is a "company" for UK corporation tax purposes (e.g. a body corporate purpose-formed to act as trustee) cannot be subject to that tax in its capacity as trustee. Section 6(1) CTA 2009 states that "A company is not chargeable to corporation tax on profits which accrue to it in a fiduciary or representative capacity except as respects its own beneficial interest (if any) in the profits". Hence corporation tax will not apply to the income and gains derived by a UK-resident corporate trustee from the assets which it holds pursuant to the trust[190]. Any fees which it earns for acting as trustee are earned by it in a beneficial capacity and are therefore subject to corporation tax.

The words "fiduciary or representative capacity" in Section 6(1) should be read fairly narrowly. In particular, they should be limited to cases where the company is clearly acting as a trustee or nominee, as those concepts would be understood under English law. A company acting as a "trustee" for these purposes could of course include not just a trustee designated under an express written trust. It could also include a company treated as a "constructive trustee" under one of the various equitable doctrines imposing constructive trusteeship to remedy a perceived wrong.

However, Section 6(1) should not apply to cases where the actual constitution of a body corporate requires it to pursue specific objects or to confer specified benefits on its members in a manner falling short of trusteeship. This is so even if those objects, etc could equally well have been pursued via a trust rather than by setting up a body corporate with specified objects. A good UK example is a company limited by guarantee formed to pursue charitable objects in its constitution. Typically, such a company will be a company limited by guarantee whose memorandum and articles of association prevent its members benefiting from the company's income and assets and require those assets to be applied solely for charitable purposes. Despite this, no trust applies to the income and assets of such a company, even if the same goals could have been pursued by setting up a charitable trust instead of a company limited by guarantee. As the High Court made clear[191], this kind of limited company does not hold its assets on trust notwithstanding its charitable mission. Even though its constitution requires it to fulfil certain purposes, it holds those assets beneficially for the purposes of the company winding-up legislation (in particular, so as to meet creditor claims). By the same token, it should be regarded as owning those assets beneficially for the purposes of Section 6(1) CTA 2009[192]. In that case, unlike a

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[189] At [2018] 4 All ER 738 at 797-8.

[190] With the partial exception of unit trusts (see 4.3.6 below), trusts which carry on an active trade or business are not automatically treated as "companies" for corporation tax purposes. This differs from the approach of the US: see 7.2.

[191] In *Liverpool and District Hospital for the Diseases of the Heart v Attorney-General* [1981] 1 All ER 994,

[192] A slightly confusing case in this regard is the Court of Appeal decision in *Von Ernst & Cie SA and others v IRC* [1980] STC 111. The issue was whether a discretionary trust fell outside the charge to Capital Transfer Tax (the predecessor of Inheritance Tax – see 5.3) because the government bonds which it held were "excluded property". That depended on the status of one of the discretionary beneficiaries which was a UK charitable company. In particular (see Buckley LJ at [1980] STC 111 at 121d) was the charitable company a "known person for whose benefit [emphasis added] the settled property or income from it had been or might be applied or who might become beneficially entitled [emphasis added} to an interest in possession in it"? In interpreting those particular words, Buckley LJ (with whom Templeman LJ concurred) said, at [1980] STC 111 at 122b-c, that "….a corporation which is by its constitution debarred from using or acquiring assets for the purposes of making or obtaining any profit for itself or its corporators, and which serves the purpose only of machinery for carrying on exclusively charitable activities, is not an object for whose *benefit* settled property or income from it can be applied or which might become *beneficially* entitled to an interest in possession in settled property within the

charitable trust, it will be subject to corporation tax, although no doubt entitled to claim various tax exemptions because of its charitable activity.

Hence a charitable company limited by guarantee should not be regarded as a trust for UK corporation tax purposes, although the distinction between a company and a trust is clearly quite a fine one. By the same token, care is needed before treating as "trusts" entities formed in jurisdictions which lack the trust concept but which may seek to achieve broadly equivalent outcomes via that entity's constitution. Entities which may fall under this heading include Anstalten and Stiftungen which are widely used for estate and tax planning in some civil law countries. Such entities may in fact be more properly regarded as "bodies corporate", although any such conclusion requires a careful review of the particular entity's constitution, and the nature of a member's interest in it (if any), under the law governing that entity.

Such a review was in fact carried out in the Canadian tax case of *Her Majesty the Queen v Peter Sommerer*[193]*.* An Austrian private foundation ("Privatstiftung") had been set up by an Austrian-resident founder. One of the potential beneficiaries of the foundation was Canadian-resident. The Canadian tax authorities sought to impute to that beneficiary certain capital gains realised on share disposals by the foundation. Both the court of first instance and the appeal court found for the taxpayer, mainly on grounds which applied even if the arrangements involving the foundation were a trust for Canadian legal and tax purposes. However, detailed evidence of the relevant Austrian law was considered by the Canadian courts. The lower court ruled that the foundation was a corporation which, on the facts, was holding its property on trust for the beneficiaries, even though the judge did not regard the foundation as "per se" a trust. The Canadian appeal court did not need to reach a final decision on this point but doubted the correctness of the lower court's decision. In effect it reached a conclusion similar to that in *Liverpool and District Hospital for the Diseases of the Heart v Attorney-General*[194]*.* Although the foundation could replicate many of the effects of a trust, it had the same right as a corporation to deal with its own property. In particular, there was nothing in Austrian law (which did not recognise the trust concept) nor in the founding documents to suggest that the foundation was holding its property other than beneficially, even though (like a corporation), it had purposes. The foundation's beneficiaries were like the members of a company: their rights were "only an inchoate right to receive distributions of corporate property from time to time at the discretion of the board of directors, and to share in the distribution of the corporate property upon its dissolution"[195].

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meaning of [the statutory language]. .....I think one must look at the character of such a body to see whether it, rather than the purposes which it exists to serve, is capable of benefiting within the meaning of the [statute] and....it is not capable of doing so. It is a mere conduit pipe, just as in my view the trustees of an unincorporated charity are". In the *Liverpool District Hospital* case, Slade J distinguished *Von Ernst* as resting on the interpretation of particular statutory words, "and not on the broader basis that a corporate charity is, ex hypothesi, in the position of a trustee of its funds": see [1981] 1 All ER 994 at 1006c. His comments are consistent with the UK law on "beneficial ownership" i.e. there can be (rare) cases where beneficial ownership of property is lacking without that property being held on trust strictly speaking e.g. the property of a company in liquidation, as discussed in *Ayerst v C&K (Construction) Ltd* [1975] 2 All ER 537. His comments are also consistent with Bridge LJ in *Von Ernst,* who was content to assume that a charitable company is not a trustee of its assets: see [1980] STC 111 at 118d.

[193] 2012 FCA 207 on appeal from 2011 TCC 212.

[194] Supra.

[195] This is not a perfect analogy because foundations do not have members in the same way as companies. The court also reached its conclusion even though the founder had the right to revoke the foundation. In such a case, where the beneficiaries only have the discretionary entitlements described in *Sommerer,* one may wonder whether the founder (rather than the foundation) beneficially owns its assets. The UK courts have reached such a conclusion in relation to trusts but only where the settlor retains a very high degree of control: see *JSC*

Unsurprisingly, there has been some confusion about the correct UK analysis of a Liechtenstein foundation or "Stiftung". The issue is discussed in part 98.9 of James Kessler QC: "Taxation of Non-Residents and Foreign Domiciliaries 2019-20" 18th edition. In brief, HMRC have been known to treat them as trusts, a view which is now shared by that author. This author thinks that it is more accurate, and more faithful to their civil law roots, to characterise them as bodies corporate, like the foundation in *Sommerer,* or indeed the company in the *Liverpool and District Hospital* case, even though they have a specified purpose and beneficiaries. They may nevertheless be "settled property" for inheritance tax purposes because of the breadth of Section 43(2) IHTA 1986: see 5.3.2. Similarly, they may fall within the wide definition of "settlement" used in specific situations for both income tax and capital gains tax. That definition is discussed in 4.2 and covers "arrangements" which may well not be trusts in the strict sense[196].

Similar comments can be made about the Liechtenstein establishment or "Anstalt". The author agrees with HMRC that an "Anstalt" should be regarded as a company, although HMRC have been known to treat it as a trust in the (rare) case where it is not carrying on a business activity and there are no "founder's rights" over the "Anstalt"[197].

Mezhdunarodniy Promyshlenniy Bank, State Corporation "Deposit Insurance Agency" v Sergei Viktorovich Pugachev and others {2017] EWHC 2426 (Ch). The beneficiaries of a foundation (unlike the beneficiaries of a trust) usually have little or no right to hold those running the foundation to account: see Philip Baker: "Beneficiaries of Trusts and Foundations" Gray's Inn Tax Chambers Review. Volume VI, No 2 (June 2007). Foundations therefore seem to be a civil law-inspired construct where the entity deliberately has no members and where the hand of the founder is intended to govern extensively, and on an ongoing basis, the foundation and its assets. In the words of one commentator, "A foundation is a juristic person which is not a corporation. It has no members. It is an autonomous patrimony dedicated to a purpose": George Gretton: "Trusts without Equity" (2000) 49 International and Comparative Law Quarterly 599 at 616. For similar remarks regarding foundations under German law, see Dr Bernd Noll in "Foundation and Trust in Succession Planning" at page 354 in Flick Gocke Schaumburg "Cross-Border Investments with Germany – tax, legal and accounting": Essays in honour of Detlev J. Piltz. Verlag Dr Otto Schmidt AG (2014). English law regards this mindset as alien, because it tends to regard a trust as an inchoate gift-over-time by the settlor. Hence it gives greater weight to the rights of any beneficiaries, even in a discretionary trust: see Andrea Vicari: "A new type of civil law trust – the theory behind the San Marino Trust law" November 2014 Trust Quarterly Review at pages 3-12. Another unusual structure for holding UK property but governed by Luxembourg law (the Grossherzogliches Fideicommis or Grand Ducal Estate) was also considered not to be a trust, in a recent UK divorce case: see Richard Frimston and Paolo Panico: "When is a Trust not a Trust? Continental property arrangements and English real estate": Trust Quarterly Review, Volume 17, Issue 2 (2019) at pages 25-30. Such entities also feature in Dutch and German succession law.

[196] See in this regard, James Kessler QC op. cit. at 98.9.5. See also Felicity Cullen "Private Foundations – an Aspect of the Remittance Basis", Gray's Inn Tax Chambers Review, Volume VIII No. 1 – November 2008. That author notes the uncertainty about whether a foundation is a company or a trust for UK tax purposes. She also notes that a foundation can be both a "company" and a "settlement" for the purposes of UK taxation of chargeable gains, if the wide definition of "settlement" applies. Hence UK-taxpaying beneficiaries may be taxable on the foundation's gains, either under the non-UK-resident "close company" attribution rules (if those beneficiaries can properly be regarded as "participators", which is doubtful given their lack of enforceable rights – see Section 454 CTA 2010) or as and when they receive "capital payments" (widely defined) from the foundation. In the regulatory area, the EU's 5th Anti-Money Laundering Directive now ensures that Article 31 of the 4th Anti-Money Laundering Directive applies to "trusts and other types of legal arrangements, such as inter alia, fiducie, certain types of Treuhand or fideicommisio, where such arrangements have a structure or functions similar to trusts." [Emphasis added]. For further discussion of the new anti-money laundering position, see Richard Frimston and Paolo Panico op. cit. at page 30.

[197] Founder's rights give the founder of the Anstalt a transferable right to decide who the beneficiaries are from time to time, which does indeed seem inconsistent with the arrangement being a trust: see the discussion at 98.10 of James Kessler QC op. cit. The author has in the past seen statements by leading UK tax counsel that an

4.1.3 Trusts as separate legal persons?

While a trust is not a separate legal person under English law, but rather a special relationship between settlor, trustee and beneficiaries, this may not be so in other jurisdictions which recognise the trust concept. For UK tax purposes, a separate non-UK entity calling itself a trust may still be properly regarded as such depending on its structure under its governing law. For example, the law of Delaware allows the creation of a statutory trust[198]. Apparently this statutory trust is a separate legal person distinct from its beneficiaries. Unless otherwise provided in its governing instrument, its beneficiaries have no interest in specific trust assets but, rather, have an undivided beneficial interest in the statutory trust. Those interests are freely transferable unless otherwise provided. A statutory trust can sue and be sued in its own name, and can execute documents in its own name via an agent. It has a perpetual existence unless otherwise provided. In particular, it may not be terminated by a beneficial owner nor by the dissolution, termination or bankruptcy of a beneficial owner.

If holders of beneficial interests have an undivided beneficial interest in all the underlying assets of the Delaware statutory trust, and that interest is enforceable against that entity, then that entity should be recognised as a trust for UK tax purposes. The fact that it enjoys a separate legal personality should not alter that conclusion[199]. Some advisers have suggested that a Delaware statutory trust is a body corporate. This is very doubtful if beneficial interest holders have an undivided beneficial interest in the underlying assets of the trust[200]. This would clash with the fundamental idea that a body corporate is a specific form of legal person which owns its assets beneficially and conducts its business, while any members merely have proprietary claims against the person itself and no interest in its underlying assets or business.

4.2 Overview of UK tax "transparency" of trusts

When taxing the income and gains of trusts (or their beneficiaries), the UK does not automatically treat beneficiaries as owning the underlying trust income and assets. Rather the trustees are treated as owning that income and those assets and are taxable accordingly. This is so even though the beneficiaries may be seen as having a form of proprietary interest in the trust fund. However, taxing the trustees is consistent with the idea that a trustee is not simply an agent of the beneficiaries. In any case, there are important exceptions to this approach.

Anstalt or Stiftung is a trust, not a body corporate, because it can be created by the wishes of a single individual and does not involve the coming together of at least two persons to form a body different from themselves. This analysis seems at odds with *Sommerer.* It also ignores the fact that under UK company law, a private limited company can have a single member.

[198] Under the Delaware Statutory Trust Act 12 Del. C. 3801 et seq.

[199] There is some similarity in this respect with Scottish partnerships where the partnership has legal personality even though the partners are regarded as carrying on the partnership business.

[200] In *Investec Trust (Guernsey) Ltd and another v Glenalla Properties Ltd and others* [2018] 4 All ER 738 at 798, Lord Mance discusses Delaware statutory trusts and does not suggest that they are anything other than trusts. The key difference with an English law trust is that the Delaware trust's assets can be accessed directly by creditors of the trust while trustee liability is more effectively limited to the trust fund alone. The trustee's role is effectively that of an asset administrator. For a discussion of how a trust can be a trust and still take the form of a legal person, or of a looser entity which is not a legal person but which still has a separate existence, see A.M. Honore: "Obstacles to the Reception of Trust Law? The Examples of South Africa and Scotland" in A.M. Rabello (ed.) "Aequitas and Equity: Equity in Civil Law and Mixed Jurisdictions" (Hebrew University of Jerusalem – 1997) at 812-814 (hereafter "Honore").

Furthermore, the income and gains of trusts will often be attributed, in particular, to the settlor (if a UK-taxable person) under special rules which cut across the basic rules for taxing the income and gains of trusts. There are in particular the so-called "settlement" rules. These not only attribute to the settlor the income and gains of trusts in the strict sense of the word. “Settlement” for the purposes of these rules includes[201] “any disposition, trust, covenant, agreement, arrangement or transfer of assets”, provided that an "element of bounty" is involved. In short, genuinely commercial arrangements are not caught[202] but difficult borderline situations can arise.

As discussed in 1.2, rules such as the "settlement" rules should (despite having a similar effect) be seen as anti-deferral rules rather than a form of tax "transparency", not least because they give rise to a partial and asymmetrical "look through" of the relevant arrangements. In particular, income and gains[203] are attributed to a particular UK taxpayer but not any losses from the underlying activities generating the relevant income and gains. In this respect, they differ from the US “grantor trust” rules (see 7.2.2 below) which apply to certain trusts as if their income and assets belonged to the “grantor” (i.e. “settlor”).

4.3 "Bare trusts"

This is the first category of trusts to consider when analysing the extent to which trusts are "transparent" for UK income tax and capital gains tax purposes.

4.3.1 Bare trusts and income tax

For income tax purposes, a "bare trust" is not defined as such[204]. However, it is taken to mean a trust where the beneficiaries have vested, concurrent interests in the trust income **and** capital. A trust with successive beneficial interests (e.g. a trust with a vested life interest followed by a remainder) cannot therefore be a "bare trust". Nor can a discretionary or accumulation trust or indeed any other trust where beneficial entitlements are contingent, not vested.

Where there is such a "bare trust", HMRC in practice ignore the trustee(s), who are not expected to file tax returns and account for tax on the trust income (although they can choose to do so). Those compliance duties fall to the beneficiaries, each in respect of their proportionate interests in the trust. Hence such a "bare trust" is a particularly clear-cut case of income tax "transparency", with beneficiaries being taxed as if each owned directly a pro rata share of the underlying trust income and assets. The trustees are effectively ignored, although, strictly speaking, they should file a tax return in respect of any otherwise untaxed trust income.

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[201] Section 620(1) ITTOIA.

[202] See for example *IRC v Leiner* 41 TC 585*; Bulmer v IRC* 44 TC 1*;* and *IRC v Levy* [1982] STC 442. See also *IRC v Plummer* [1979] STC 793 although the effective result of this case was later reversed on other grounds in *Moodie v IRC* [1993] STC 188.

[203] Before this legislation was rewritten in 2005, it imposed a standalone income tax charge under the old Schedule D Case VI. By contrast, although it now sits in Part 5 (Miscellaneous Income) ITTOIA, it purports (see for example Section 624(1) ITTOIA) to tax directly the underlying income from that “settlement”, whatever its particular source(s).

[204] However, for the purposes of Part 9 ITA, which deals with the income taxation of “settlements” (see 4.3.5 below), “settled property” does not include (see Section 466(2) ITA) property held by a person as nominee for another person; or as trustee for another person who is absolutely entitled as against the trustee; or who would be so absolutely entitled if that other person was not an infant or otherwise lacking legal capacity.
The language of Section 466(2) closely resembles Section 60 TCGA 1992: se 4.3.2.

This approach is consistent with the Privy Council decision in *Hardoon v Belilios*[205]. There the court ruled that a trustee holding the legal title to bank shares for a single fully-vested beneficiary of full capacity was entitled to an indemnity from the beneficiary for the costs of doing so (including meeting unpaid calls on the shares in a liquidation). Furthermore, that indemnity was not limited to the trust property. As Lord Lindley, giving the sole judgment, said:

"The plainest principles of justice require that the cestui que trust [i.e. the beneficiary] who gets all the benefit of the property should bear its burdens unless he can show some good reason why his trustee should bear them himself".

4.3.2 Section 60 TCGA 1992

4.3.2.1 *The "transparency" rule*

For capital gains tax, the "transparency" of such "bare trusts" is explicitly provided for in Section 60 TCGA. This states:

> "(1) In relation to property held by a person as nominee for another person or as trustee for another person **absolutely entitled** as against the trustee, or for any person who would be so entitled but for being an infant or other person under disability (or for two or more persons who are or would be jointly so entitled), **this Act shall apply as if the property were vested in, and the acts of the nominee or trustee in relation to the property were the acts of, the person or persons for whom he is the nominee or trustee (acquisitions from or disposals to him by that person or persons being disregarded accordingly)** [Emphasis added]
>
> (2) It is hereby declared that references in this Act to any property held by a person as trustee for another person absolutely entitled as against the trustee are references to a case where that other person has the exclusive right, subject only to satisfying any outstanding charge, lien or other right of the trustees to resort to the property for payment of duty, taxes, costs or other outgoings, to direct how that property shall be dealt with."

There has been significant litigation regarding what is now Section 60. In particular its scope is wider than an initial reading might suggest. To fall within it, interests of beneficiaries must be fully vested, not contingent. They must also be of the same quality, if not quantity. So Section 60 will cover a trust for A, B and C holding vested concurrent interests of 40%, 35% and 25% in the trust property. Their interests may differ in quantum but they are qualitatively the same because they are fully vested **concurrent** interests. If they were vested **successive** beneficial interests (e.g. an interest for life with remainder), then Section 60 would not apply[206]. In Section 60(1), the word "jointly" is not limited to the co-ownership concept of "joint tenancy" under English property law. It covers other forms of co-ownership as well, so long as the interests are concurrent and fully vested[207].

If the trust property consists of land or (possibly) a controlling shareholding in a private company or mortgage debts[208], and there are several vested concurrent beneficial interests in that property, then a holder of one of those interests may not be "absolutely entitled" as against the trustee(s) for Section 60 purposes. This is because the nature of the trust property is such that it cannot be

[205] [1901] AC 118. This was an appeal from the Hong Kong courts. It was not a tax case.
[206] See *Stephenson v Barclays Bank Trust Co Ltd* [1975] STC 151.
[207] See *Kidson v MacDonald* [1974] STC 54.
[208] HMRC regard the same principle as applying where the trust property consists of a single work of art such as an old master: see CG37560 in the Capital Gains Manual (accessed 9 June 2020). .

subdivided without being sold in its entirety. This point was first raised by Walton J in *Stephenson v Barclays Bank Trust Co Ltd*[209]and was further developed in the High Court in *Crowe v Appleby*[210]. In that case, freehold land was held on trust for sale, initially for several concurrent life interest holders. Some but not all of those life interests came to an end. Goff J ruled that those holding fully vested reversionary interests in those parts of the trust property where the life interests had ended were not "absolutely entitled" as against the trustee under what is now Section 60, despite their interests being fully vested. In particular, so long as all the life interests had not come to an end, those reversionary holders were not able to "direct how that property shall be dealt with" for Section 60(2) purposes because they only had fractional interests in a single non-fungible asset. They could not call for immediate transfer of their respective shares in that asset nor interfere with the trustees' discretion to postpone sale. This would remain the case unless and until the trustee sold the land (e.g. at the direction of all the reversionary beneficiaries after all the life interests had ended). At that point, they could call for their shares of the cash proceeds. Only then would their interests in the trust fall within Section 60[211]. This had an important impact on the capital gains tax treatment of the sale of the land, all of which remained, until sale, "settled property" within a single trust which was a separate taxable entity in its own right, unlike a trust falling within Section 60[212].

Section 60 applies to vested interests even if they are held by minors or persons under some legal disability. However, it will not apply where the interest of a person is expressly defined under the terms of the trust as a contingent interest which only vests on reaching the age of majority. This can lead to fine questions of interpretation of the relevant trust.[213] The language in Section 60(2) regarding charges and liens is to be read fairly restrictively. In particular, where there is a beneficial interest in the trust property (such as an annuity), which ranks prior to the main beneficial interests which purport to be within Section 60, that prior interest will not be a "charge" within Section 60(2). Hence there will be successive interests and Section 60 TCGA 1992 will not apply in this situation[214].

A person can be "absolutely entitled" as against a trustee for Section 60 purposes even if that person is not itself a "beneficial owner" of the relevant interest in the trust e.g. where A, B and C co-own the

[209] [1975] STC 151 at 164. He also ruled that Section 60 was intended to apply in the same way regardless of the underlying trust assets, unless the individual beneficial interests vested at different times.
[210] [1975] 3 All ER 529. Goff J's decision was affirmed by the Court of Appeal on other grounds in *Pexton v Bell and another, Crowe v Appleby* [1976] STC 301. For a discussion, in a non-tax context, of how best to equitably satisfy concurrent beneficial interests in the shares of a private company all of which are held on trust, where one of those beneficial interests is greater than half the shares, see *Lloyds Bank plc v Duker* [1987] 3 All ER 193. In particular, an absolute entitlement under a will to a minority interest in the shares was best satisfied by ordering a sale of all the company shares, followed by a proportionate split of sale proceeds.
[211] HMRC consider that this principle does not apply to land in Northern Ireland where the Law of Property Act 1925 does not apply so as to impose a trust for sale in the case of joint ownership of land. Hence a beneficiary of an Irish trust can call upon the trustees to transfer an undivided share in real property. The position in Scotland is different again: although the Law of Property Act 1925 does not apply there either, under Scottish trust law a beneficiary with a part-share in trust property will not be absolutely entitled before trustees indicate that particular property has been appropriated to that beneficiary, unless all beneficiaries have become absolutely entitled to the trust property. The Scottish thinking is that generally, until the trustees have indicated that particular property has been appropriated to the beneficiary, the latter cannot claim an absolute entitlement to a fraction of any trust asset before all beneficiaries have become absolutely entitled to the trust property: see *Stenhouse's Trustees v Lord Advocate* [1984] STC 195. The same principle applies under English law where, before all beneficiaries have become jointly absolutely entitled to all the trust property, the trustees retain an express power to appropriate specific assets so as to satisfy a beneficial share. See CG37530-1 and CG37550-1 in the Capital Gains Manual (accessed 8 June 2020).
[212] See 4.3.4.
[213] See *Tomlinson v Glyn's Executor and Trustee Company* [1970] STC 381.
[214] See *Stephenson v Barclays Bank Trust Co Ltd* [1975] STC 151, although see also 4.3.2.3 in this regard.

shares of a company equally via a trust and C is itself the trustee of a second trust for D for life with a remainder to E[215].

Scotland has its own law of trusts which differs in some respects from English trust law. This is discussed further in 4.3.3.2. In particular, Scottish trust law recognises a form of trust called a "trust for administration" which can be revoked in the settlor's (or, to use the correct Scottish term, the truster's) own favour. A "trust for administration" can nevertheless fall within Section 60 TCGA, even though it might appear to create successive interests in the trust property. Factually, it can be difficult to identify whether a particular trust is in fact a "trust for administration"[216].

4.3.2.2 *Pooled property*

So long as beneficial interests are fully vested, it does not matter that they are interests in separate items of property which have been pooled by the beneficiaries via a trust and placed under certain restrictions as a consequence. Section 60 can still apply to that pooled property, as demonstrated by *Booth v Ellard*[217]. In that case, shareholders in a private company transferred their shares to trustees to hold them under what was in effect a shareholders' agreement. An aim of this arrangement was to ward off a possible takeover bid. The trustees could therefore vote all the shares held in trust in accordance with a majority vote of the beneficiaries: unanimity was not required. Each shareholder put a number of shares into trust in return for a pro rata beneficial share of the total number of shares in trust which reflected the number of shares which that shareholder contributed. The shareholder was effectively entitled to the return of the same number of shares as he had contributed, when the arrangements were unwound. The High Court and the Court of Appeal concluded that Section 60 applied to the trust. Hence there was no disposal for tax purposes when shares were put into trust even though the shareholder was giving up individual ownership of a number of shares in return for an equivalent co-ownership interest in a larger block of shares which were subject to various restrictions e.g. on voting. In the Court of Appeal, Buckley LJ made the following comments[218]:

> "Can it, then, be argued successfully that in the present case all the several settlors did in fact make a chargeable disposal of their shares because under [Section 60] all the shares which are subject to the trust are to be treated as vested in the settlors collectively, whereas before the inception of the trust they were vested in them severally? I think not. The effect of the trust was to subject all the trust shares to powers and discretions conferred on the trustees for what was conceived to be the collective benefit of the settlors but, subject to those powers and discretions which the settlors collectively could override, **the measure of the beneficial interests of the settlors remained unaffected by the trust. There was no transfer of any beneficial interest from any one of them to any other** [emphasis added]".

Oliver LJ added[219]:

> **"[The beneficiaries'] interests in the mass precisely reflect the individual interests which they had before the [trust] deed was entered into**…….This was no more than a shareholders' voting agreement carried out through the medium of a trust, and it would seem capricious and unreasonable to tax these shareholders on a wholly illusory gain simply because of the technical

[215] See also *Hoare Trustees v Gardner* [1978] STC 89.
[216] See CG34430 in HMRC Capital Gains Manual (accessed 8 June 2020).
[217] [1978] STC 487 upheld at [1980] STC 555.
[218] At [1980] STC 555 at 560.
[219] At [1980] STC 555 at 562.

machinery which they chose to adopt to effect an end which involved no quantitative alteration in their separate and individual beneficial entitlements."

There may have been an element of fungibility about the private company shares placed in trust in *Booth v Ellard*. There was no such fungibility in *Jenkins v Brown*[220] where Section 60 was held to apply where family members had used a trust to pool different pieces of farmland. As in *Booth v Ellard*, beneficial interests in the trust were calculated as a proportionate share of the aggregate value of the various items of property subjected to the trust, with that share corresponding to the value of what each participant had put in. In *Jenkins v Brown*, the judge ruled that when a participant withdrew the same piece of land he had put in, there was no disposal for capital gains tax purposes. That participant was simply realising his proportionate interest in the overall pool. There was no question of any trust beneficiary disposing of a fractional interest in that land, when it was withdrawn. The logic of the judge's reasoning suggests that there would also have been no disposal if the participant had taken back another piece of land equal in value to what he had put in[221]. In this respect, the judge was applying *Booth v Ellard* to non-fungible property but in doing so, he stressed that[222]:

> "What the judgment of Buckley LJ is not based on, in my view, is an analysis of the particular subject-matter of the trust……The test that he applied was the measure of the beneficial interests of the settlors remaining unaffected [by putting property into the trust]."

He continued[223]:

> "…the basis of the reasoning of the Court of Appeal in *Booth v Ellard* [is] that one looks at the mass and not at the individual case in transactions such as the present, where property was put into a pool, and where that result is reached (that the interests in the mass precisely reflect the individual interests before the [trust] deed was entered into) there is for capital gains tax purposes no disposal".

HMRC note[224] that because of Section 43 TCGA 1992, the base cost of a participant in the pool on an eventual disposal of the asset taken out of the pool should be the original cost of the first asset contributed to the pool by that participant.

The courts have therefore steered away from a theoretical interpretation of Section 60 which would treat beneficiaries with vested concurrent interests in a trust of pooled property as if they had each disposed of an undivided interest in the property which each put into the trust, in return for a fractional interest in each and every other asset in that trust[225]. The same "no disposal" approach

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[220] [1989] STC 577. There is no discussion in *Booth v Ellard* about the point discussed above regarding

[221] In particular, at [1989] STC 577 at 588, he said: "Again, on questions of value advice had been taken and it is not disputed but that the property that was distributed out to the various people with absolute interests [in the trust] …..so far as might be accurately reflected their proportional entitlements [under the trust]. **It was a coincidence that they took out what they had originally put in**. [Emphasis added] That happened because the values inter se of the several properties had not altered enough to make a difference and it was therefore possible to undo what had been done [when the trust was set up] without altering the proportions in which the beneficiaries were entitled." See also in this regard Tiley's Revenue Law (9th edition): Glen Loutzenhiser at page 775.

[222] [1989] STC 577 at 594.

[223] [1989] STC 577 at 595.

[224] At paragraph CG34380 of the Capital Gains Manual (accessed 8 June 2020).

[225] This pragmatic approach avoids taxpayers being chargeable to tax on technical disposals of fractional interests in pooled assets when taxpayers contribute to or exit the Section 60 trust. This is especially important because they are unlikely to have realised any cash on such a disposal with which to pay any tax. This approach

applies in reverse when property is taken out of that trust. In both situations, it is key that the beneficiary's proportionate interest in the trust should reflect the value of what that beneficiary contributed, relative to the value of the other trust assets at the time when the beneficiary made its contribution.

This approach has a number of consequences. If another person subsequently contributes chargeable assets (which could include non-sterling currencies) to the pool in return for becoming a beneficiary, then there should be no disposal by any party provided that the new beneficiary's proportionate interest in the pool reflects the relative value of his contribution to that expanded pool.

If that person instead contributes sterling cash to the pool in return for becoming a beneficiary, then because sterling is not a chargeable asset[226], the logic of *Booth v Ellard* and *Jenkins v Brown* does not apply. In that case, there would be disposals to that contributor, by the other pool participants, of fractional interests in any other chargeable assets within the pool.

In a pooling of non-fungible assets, the relative values of assets may change within the pool without, apparently, triggering a chargeable gain or an allowable loss on a withdrawal of property. Suppose A contributes Blackacre, B contributes Whiteacre and C contributes Greenacre and at that time, each plot of land was worth 30. Each of A, B and C therefore acquires a one-third interest in the trust. Suppose the value of Greenacre then doubles while that of Blackacre and Whiteacre remains unchanged. Hence the value of the trust assets is now 120. C now wishes to have returned to him his one-third interest in the trust, which is now worth 40. That is not a taxable event because his "interest in the mass" is equated with both the asset he put in and the asset(s) he gets out. Effectively he is treated as getting back the asset he originally put in, which happens to have gone up in value by one third (10/30). The same applies to A and B even though their beneficial shares will have each been enhanced by 10, purely because of the doubling in value of Greenacre, which was not contributed by either of them but by C.

Jenkins v Brown may in fact give scope for avoidance. Suppose A and B pool in a trust two pieces of land of equal value where A's base cost in the land he contributes is much higher than B's in the land that B contributes. B had wished to dispose of that land but was deterred from doing so by the size of the potential gain, given his low base cost. However, A could subsequently withdraw from the pool and dispose of the land contributed by B but with the benefit of the much higher base cost in the land which A put into the pool. B will remain beneficial owner of the unsold land contributed by A. Of course, B will have the same base cost in that land as in the land which B actually put into the pool (and which has now been withdrawn from the pool by A). There is therefore scope for "shifting" base costs to achieve a tax saving.

One final point is that the court in *Booth v Ellard* and in Jenkins *v Brown* made no mention of *Crowe v Appleby*[227]. In short, neither court raised concerns about the beneficiaries of the pooling

differs from the approach taken by HMRC to partnerships (i) in Statement of Practice D12 (and in particular paragraph 3 of SP D12) which interprets Sections 59 and 59A TCGA; and (ii) in Business Brief 3/08 of 21st January 2008 (now incorporated in SP D12 as a new paragraph 5), which deals with contributions of assets by a partner to a partnership. This divergent approach is odd because, in particular, Sections 59 and 59A impose on partnerships and UK limited liability partnerships a look-through approach which has similarities with Section 60 TCGA. As the introduction to SP D12 itself says, each partner/member of a limited liability partnership "has…to be regarded…as owning a fractional share of each of the partnership assets and not an interest in the partnership itself". Sections 59 and 59A are discussed in more detail in Appendix A below.

[226] Section 21(1)(b) TCGA 1992.

[227] [1975] 3 All ER 529.

arrangements not being "absolutely entitled" as against the trustee because of the nature of the underlying assets (a controlling interest in a private company and land). Presumably this was because beneficiaries had fully vested concurrent interests so that they could in fact withdraw assets from the pool relatively easily. Therefore they were all able to "direct how that property shall be dealt with", for Section 60 purposes. Of course that was not the case on the facts of *Crowe.*

4.3.2.3 *Sections 248A-E TCGA 1992*

In 2010, Sections 248A-E TCGA were enacted[228]. These sit alongside *Jenkins v Brown.* They apply[229] where a person (the "landowner") co-owns land with another person ("the co-owner"), but then disposes of an interest in that co-owned land for consideration which is or includes an interest in other land held jointly by the landowner and the co-owner. The legislation seems to relate only to UK land (and not to non-UK land or to other assets which could be pooled, such as the private company shares in *Booth v Ellard*). Section 248B(1) and (2) gives the landowner capital gains tax deferral relief in respect of the interest which it disposes of. The extent of that deferral will depend in part on whether the amount or value of the consideration for the relinquished interest in land is less than, the same as or greater than the market value of that interest[230].

These rules do not apply in respect of land which is eligible for relief from capital gains tax as a private residence[231]. Separate rules in Section 248E provide relief on disposing of joint interests in a private residence[232].

Sections 248A-E can only operate where there is a disposal by the landowner in the first place. *Jenkins v Brown* provides that there is no disposal if a beneficiary under a Section 60 TCGA trust simply withdraws from the pool of trust assets an amount which corresponds to the percentage of the pool which it provided in the first place. Similarly, putting those assets into the trust in the first place, in return for a proportionate beneficial interest, should not result in disposal.

4.3.2.3 *Flexible scope of Section 60*

The relative flexibility of Section 60 TCGA 1992 and the courts' willingness to apply their transparency rationale in a pragmatic way (so as to avoid technical tax charges) is further illustrated by the decision of Goulding J in *AndersUtkilens Rederi A/S v O/Y Lovisa Stevedoring Co A/B and Keller Bryant Transport Co Ltd*[233]. *Anders* arose from a court order underpinning a litigation settlement. In that order, a court had ordered the defendant to sell its premises and certain other assets and to divide the proceeds with the plaintiff. The question arose whether that order created a trust over the property to be sold and thereby triggered a disposal for the purposes of corporation tax on chargeable gains when that property was put into trust. Any such tax was potentially deductible, under the settlement terms, from the amounts to be shared between plaintiff and defendant. Goulding J ruled that because an

[228] Replacing Extra-Statutory Concession D26.
[229] Section 248A TCGA.
[230] See paragraphs CG73000 et seq. of the Capital Gains Manual and in particular the worked examples at CG73008 (accessed 9 June 2020). Not all situations will qualify for a full deferral of tax.
[231] Section 248A(6) and Section 248C TCGA.
[232] Section 248D also deals with the case where EU "milk quota" is associated with the relevant land.
[233] [1985] STC 301. Goulding J was the High Court judge in *Booth v Ellard* [1978] STC 487.

order for specific performance would have been given in support of the court order, an immediate constructive trust was indeed created over the premises and other assets. It was, however, a trust within Section 60 TCGA and the beneficiaries were the plaintiff and the defendant.

He commented in particular[234]:

> "Counsel for the plaintiff seeks to distinguish the present case [from *Booth v Ellard*] because the defendant alone [in the present case] was entitled to the income (if any) arising from the property before the sale. Thus, he says the trust provided for successive interests, and the interests as co-owners of the plaintiff and defendant only became similar when the property was sold. However, that distinction has to be evaluated in the light of the parties' express and immediate duty to one another to obtain an early sale of the property, and in that context it seems to me altogether too technical and refined to exclude the application of [Section 60 TCGA 1992]. Like Oliver LJ in *Booth v Ellard,* I am happy to reach a conclusion that seems to me to accord with common sense and commercial reality.
>
> From and after making the compromise, the plaintiff and the defendant are accordingly to be treated as co-owners of the property under [Section 60]. It follows, I think, first, that the compromise effected a part-disposal of the property by the defendant to the plaintiff within the scope of [Section 60 TCGA 1992], and second, that each of the parties subsequently made a disposal of its own interest to the final purchaser. The incidence of taxation must be ascertained accordingly."

In that case, the UK tax authorities were offered the opportunity to be joined as parties to the case but declined. This is strange not least because the beneficial interests under the trust were drafted not as fixed pro rata shares of the trust property but as vested interests which varied in quantum under a financial "waterfall". In essence, the parties' percentage interests in the "net sales proceeds" of the property could vary, depending on the proceeds realised. If those proceeds did not exceed £105,000, then the plaintiff was entitled to 100%. Nevertheless, the beneficial interests under the trust were implicitly recognised by Goulding J as vested and concurrent, even though there were circumstances in which the defendant's beneficial interest would have no economic value. A similar approach to defining beneficial interests has been adopted in receivables trusts for segregating cashflows in securitisation transactions. These seem to have been accepted by the UK tax authorities as falling within Section 60 TCGA, presumably on the basis of *Anders.*

Goulding J's dismissal of the argument that there were successive interests also seems quite "broad brush", especially given the decision in *Stephenson v Barclays Bank Trust Co Ltd*[235] on whether a prior beneficial interest (in that case, an annuity) could be a "charge" within Section 60(2).

Section 60 therefore imposes for capital gains tax purposes a rather radical form of transparency by disregarding the trust entirely and treating the beneficiaries as the co-owners of the trust property[236]. The courts have been prepared to apply it quite flexibly and commercially, in order to minimise purely technical taxable events. However, there are limits. In particular, where there are vested concurrent beneficial interests under a Section 60 trust, that section by itself does not permit any beneficiary to

[234] [1985] STC 301 at 307.

[235] [1975] STC 151.

[236] See in this regard Fox J (as he then was) in *Harthan v Mason* [1980] STC 94 at 97, a case involving co-ownership of land in the usual form of a trust for sale.

claim sole entitlement to any particular asset of the trust, for tax purposes. Rather each beneficiary has a fractional co-ownership interest in each and every trust asset[237].

This radical form of transparency also has drawbacks. It means that chargeable gains (whether distributed or not) and allowable losses on any disposal of underlying trust assets will accrue pro rata to each and every beneficiary. A disposal will also arise where beneficiaries' fractional interests in trust assets are varied, even if no underlying asset is disposed of e.g. where a beneficiary sells part of his beneficial interest to a third party. Hence the radical approach of Section 60 can give beneficiaries the compliance burden of tracking over time their fractional interests in a pool of underlying trust assets which may change. They also risk incurring unfunded tax liabilities if they lack funds to pay tax arising when they are treated as disposing of a fractional interest in a trust asset. This could, for example, happen where the trustees do not distribute the proceeds of selling an underlying asset.

4.3.3 Trusts with a vested interest in possession: income tax

Where the beneficial interests in trust comprise a vested interest in income only, followed by an interest in remainder, there is a notable divergence between the income tax rules and the capital gains tax rules. The latter are discussed at 4.3.4. The income tax rules offer a degree of "tax transparency" for the holder of the interest in income. This form of "transparency" differs from that discussed above in relation to "bare trusts".

4.3.3.1 The "rule in Baker v Archer-Shee"

A succinct summary of the income tax position in relation to life interest trusts with a vested income beneficiary was provided by Vinelott in *IRC v Berrill*[238]:

> "Under English law a beneficiary entitled to the income of trust property under a trust instrument which contains no power of accumulation is entitled to the income of each asset comprised in the trust property; **each asset constitutes a separate source of income** [emphasis added]. In *Baker …..v Archer-Shee* [1927] AC 844 at 866….., Lord Wrenbury, describing the life interest of Lady Archer-Shee under a will governed by the law of New York (on the assumption, afterwards shown to be incorrect, that the law of New York was the same in this respect as the law of England) said:
>
>> 'It is, I think, if the law of America is the same as our law, an equitable right in possession to receive during her life the proceeds of the shares and stocks of which she is tenant for life. Her right is not to a balance sum, but to the dividends subject to the deductions as above mentioned. Her right under the will is "property" from which income is derived."
>
> The principle applies when the beneficiary is entitled to the income of trust property subject to an annuity (see *Nelson v Adamson…*[1941] 2 All ER 44…..) or subject to a charge for administrative expenses or the trustees' remuneration, although, of course, a deduction can be made of the amount of the annuity and of the expenses and remuneration in ascertaining the beneficiary's total income. If on the other hand, a beneficiary has no right to receive income but is paid income (or a sum which for tax purposes falls to be treated as income) in the exercise of a discretion, the exercise of the discretion constitutes a new source of income (see *Cunard's Trustees v Inland Revenue Commissioners* …..27 TC 122 at 132, per Lord Greene MR."

[237] Subject to the approach to pooled assets in *Booth v Ellard* and *Jenkins v Brown.*
[238] [1981] STC 784 at 797.

However, in order to understand the position better, one needs firstly to understand the basis on which income tax is charged **on the trustees** of a trust which is not a "bare trust" but where there is nevertheless a vested beneficial interest in trust income. In particular, that income can be charged at the basic rate of income tax (or, in the case of dividends, at the "dividend ordinary rate") on any person "receiving or entitled" to that income[239]. A beneficiary with a vested interest in the trust income can be charged as a person beneficially "entitled" to that income. However, a trustee can also be charged on that trust income as a person "receiving" or "entitled" in law to it. It has been established that this charge on the trustees is a "representative" charge only. In other words, the trustee charge can be disapplied if and to the extent that a beneficiary with a vested interest in the same income would not have been taxable in the UK. The consequence is an element of tax transparency: one must look through the trustee to the identity of the beneficiary, in order to determine whether and how the trustee is taxable.

In particular, this "receiving or entitled" language was considered by the House of Lords in *Williams v Singer; Pool v Royal Exchange Assurance*[240], where an assessment was raised on a UK-resident trustee of a trust which owned US shares and whose sole vested income beneficiary was non-UK-resident and non-UK-domiciled. Furthermore, the trustees had mandated that the dividends on the shares should be paid directly to the non-UK bank account of the beneficiary, so that no dividends were received in the UK. Viscount Cave (with whom Lords Atkinson and Shaw concurred) made the following comments[241]:

> "In short, the intention of the [Income Tax] Acts appears to be that, where a beneficiary is in possession and control of the trust income and is sui juris, he is the person to be taxed, and that, while a trustee may in certain cases be charged with the tax, he is in all such cases to be treated as **charged on behalf or in respect of his beneficiaries, who will accordingly be entitled to any exemption or abatement which the Acts allow** [emphasis added]. Applying the above conclusions to the present Case, it follows, in my opinion, first that the .....trustees, who have directed the trust income to be paid to the beneficial tenants for life and themselves receive no part of it, are not assessable to tax in respect of such income; and secondly, that, even if they were so assessable, they would be assessable as trustees on behalf of the life tenants, who would accordingly be [exempt on the basis that they are neither domiciled nor resident in the UK]."

Lord Wrenbury said[242]:

> "…These sections point to the conclusion that the person to be taxed is the beneficiary, not the trustee, and nonetheless because under certain circumstances the beneficiary is to be reached through the trustee. If the trustee is a foreign subject resident abroad but the beneficiary is in the United Kingdom, taxation will not be escaped and, if the trustee is a British subject resident in the United Kingdom but the beneficiary is a foreign subject resident abroad, taxation is not imposed by reason of those facts….".

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[239] See Section 8 (trading income), Section 271 (property business income), Section 371 (interest), Section 385 (dividends and other distributions), Section 404 (non-UK dividends) and Section 581 (royalties) ITTOIA. These rules do not apply for corporation tax purposes: that tax is charged solely on any corporate beneficiary of the trust in question and not on the trustee. This is consistent with Section 6(1) CTA 2009: see 4.1.1 above. For the charge to tax at the basic rate, see Section 11. For the charge to tax at the dividend ordinary rate, see Section 14 ITA.
[240] 7 TC 387.
[241] 7 TC 387 at 412.
[242] 7 TC 387 at 414.

The court made clear that the charge on trustees in such cases was a representative charge and the conclusion would not have differed if there had been no dividend mandate[243], because the underlying income had a non-UK-source and the vested income beneficiary was non-UK-resident. In short, taxing the trustee in this case would have amounted to an extraterritorial extension of the UK taxing jurisdiction. The trustees' decision to direct the trust income to the tenant for life simply confirmed that the trustees were not persons "receiving or entitled" to the income anyway.

The Court of Session in *Reid's Trustees v Inland Revenue Commissioners*[244] further considered this "receiving or entitled" language. In that case, the trustees were UK-resident as were the beneficiaries and the trust income was UK-source. Lord President Clyde in particular stated that[245]:

> "….trustees, albeit only the representatives of ulterior beneficial interests, are assessable generally in respect of the trust income [on the basis that they are receiving or entitled to it]; but….- just because they represent those beneficial interests – they may have a good answer to a particular assessment, as regards some share or part of the income assessed, on the ground that such share or part arises or accrues beneficially to a cestui que trust [i.e. a beneficiary] in whose hands it is not liable to Income Tax….".

The situation in *Baker v Archer-Shee*[246] was the converse of *Williams v Singer.* While the underlying trust income was non-UK-source, it was the beneficiary with a vested life interest in trust income who was UK-resident. The trustees were non-UK-resident. The key question was whether the life interest holder was to be treated as entitled beneficially to the underlying income of the trust as it arose. Put another way, was the life interest holder entitled as such to income which could be characterised as dividends if the trust had invested its capital in dividend-yielding shares? Alternatively, was the holder of the life interest merely entitled to require the trustees to administer the trust and its assets appropriately and to hand over a simple balance sum of indeterminate trust income to the life interest holder, after relevant trust expenses had been deducted? As discussed below, the House of Lords, by a bare majority, ruled that the life interest holder was entitled beneficially to the underlying income of the trust as it arose and not entitled merely to a simple balance sum[247].

The background to *Baker* was an important change made on the eve of the First World War by David Lloyd George, the then Chancellor of the Exchequer, to the "remittance" basis rules. These rules had hitherto enabled UK-residents to defer income tax on all non-UK-source income which fell within the old Schedule D Case V as being income from a "foreign possession". Income tax was payable only when it was "remitted" (in essence, repatriated) to the UK. Finance Act 1914 denied many UK-residents the benefit of the "remittance" basis where the non-UK-source income was income from a "foreign possession" but in particular was derived from "stocks, shares or rents". The "remittance"

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[243] The House of Lords noted that even if the income was mandated, the trustees still had limited tax information filing obligations under what became Section 76 TMA, and which was repealed in 2011.

[244] 14 TC 512. Aspects of *Reid's Trustees* have been questioned on the basis that Lords Clyde and Blackburn incorrectly said that the trustees were "entitled" to the trust income whereas Lord Morison correctly said that they merely "received" it and were accordingly taxable: see Avery Jones, John F. and others: "The Treatment of Trusts under the OECD Model Convention". European Taxation, December 1989, 379 at 384 fn 39 (hereafter "Avery Jones: Trusts"). While Lord Morison's statement cannot be faulted, this author considers that the trustees were also "entitled" to the trust income (and Lord Morison suggests as much at 14 TC 530). Even under English trust law, they would have been legal owners of that income and, in any case, under Scots trust law (which applied in *Reid's Trustees)* the trustees alone can own trust income and assets.

[245] 14 TC 512 at 525.

[246] 11 TC 749.

[247] See the citation supra from the judgment of Vinelott in *IRC v Berrill* [1981] STC 784 at 797.

basis was preserved if, by contrast, the non-UK-source income was derived from a "foreign possession" other than "stocks, shares or rents"[248].

Under the then rules, the husband of Lady Archer-Shee was assessed to income tax in respect of her income from a New York trust in which she held a life interest and where the income was not all "remitted" to the UK. The question was whether that life interest was a "foreign possession" entitling the holder to the income of the underlying trust assets as it arose. If so, then if that underlying income was derived from "stocks, shares or rents", the "remittance basis" was unavailable.

The case was first heard by Rowlatt J in the High Court who, like the Special Commissioners, found against the taxpayer. He firstly analysed the nature of the life interest and concluded that[249]:

> "What this lady enjoys is not the stocks, shares and rents or other property constituting the trust fund under the will; what she has is the right to call upon the trustees, and, if necessary, to compel the trustees, to administer this property during her life so as to give her the income arising therefrom according to the provisions of the trust. **Her interest is merely an equitable one, and it is not an interest in the specific stocks and shares constituting the trust fund at all….But the question is whether that is so for the purposes of income tax** [emphasis added]".

Despite the trust law position, he decided that, for income tax purposes, Lady Archer-Shee was entitled to the underlying income of the trust and therefore, the "remittance" basis was unavailable to the extent that this income was derived from "stocks, shares or rents"[250]. He was aware that his decision created complications e.g. if there were two concurrent life interest holders, only one of whom was UK-resident, and the trust was invested in non-UK stocks and shares as well as other "foreign possessions". To what extent was the UK-resident life interest holder entitled to the income from the non-UK stocks and shares?

The Court of Appeal reversed Rowlatt J and found for the taxpayer. In essence, they agreed with Rowlatt J's analysis of the life interest as a matter of trust law but and thought that this dictated the income tax outcome. As Lord Hanworth MR put it[251]:

> "…what they [i.e. the trustees] remit is not what I will call the dividends in specie in their actual form….They do not remit the whole of the income from the profits, but they remit a sum which has lost its origin or parentage; it has lost the shape of dividends, share warrants, or the like, and is merely a sum of money which represents the balance after payment of the sums which would properly fall upon the trust."

Hence the income was derived from a "foreign possession" but was not derived from any underlying "stocks, shares or rents" arising to the trustees In reaching this decision, the Court of Appeal relied in part on the House of Lords' earlier decision in the probate duty case of *Lord Sudeley v Attorney-*

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[248] See Case V Rule 2 of Schedule D as it then was. The 1914 changes to the "remittance" basis were to some extent an anti-avoidance measure. They may also have been motivated by the increasing likelihood of a major war and the need to fund it. The 1914 changes and the wider evolution of the "remittance" basis (although not the major changes to that basis in 2008 and subsequently) are discussed in greater detail in *Taxing Foreign Income from Pitt to the The Tax Law Rewrite – the Decline of the Remittance Basis.* John F. Avery Jones CBE. Studies in the History of Tax Law, ed Tiley, Hart 2004, page 15.

[249] [1927] 1 KB 109 at 116.

[250] [1927] 1 KB 109 at 117. In this regard, he relied on *Williams v Singer* 7 TC 387, which in his view was based on allowing the non-UK-resident income beneficiary to look through the UK trustees to the underlying non-UK income of the trust.

[251] [1927] 1 KB 109 at 120.

General.[252] In that case, an estate was still being administered under an English law will. The court held that a beneficiary's right to residue of that estate was simply a right situated in England to have the executors administer the estate properly. It was not a right to any underlying non-UK property (in particular, mortgages on New Zealand real property) within the estate assets[253].

The Court of Appeal was reversed by a bare majority of the House of Lords. The main judgment for the majority was given by Lord Wrenbury. The essence of that judgment has already been set out in the citation (supra) from *IRC v Berrill*[254]. Lords Atkinson and Carson gave supporting judgments (the latter seeming to argue that the non-UK trustees could effectively be ignored on the basis of *Williams v Singer*[255]). The result was that the "remittance" basis was not available. There were indications that the judges (Lord Wrenbury in particular) were aware of the anti-avoidance purpose of the 1914 legislation and were reluctant to allow interposing a trust between relevant assets and a non-UK-resident beneficiary to frustrate that purpose[256]. Furthermore, all the judges ruled on the basis that New York trust law was the same as English trust law (no evidence having been provided of New York trust law).

There were two strong dissenting judgments. In particular, Viscount Sumner ruled that, under English law:

> "Lady Archer-Shee …..does not for Income Tax purposes own and is not entitled to any of the stocks, shares, securities or real property that form part of the New York trust estate. These belong to the trustee company, to whom also the annual payments made in respect of them by way of rent, interest or dividends 'arise', 'accrue' and 'belong'. All that she has is a right, in the forum of the trustee and of the trust fund, to have the trust executed in her favour…..and this 'possession' neither consists in the trust's investments or any of them, nor is situated here. It is 'foreign'."[257]

On that basis, the life interest holder was entitled to the "remittance" basis because her income was derived from her interest in the non-UK trust and not from the underlying trust investments. That trust interest was a "foreign possession" other than "stocks, shares or rents". The dissenters also noted the problem which Rowlatt J had already identified if the majority were correct i.e. how to apportion trust income derived in part from stocks, shares and rents if there were two concurrent life interests in the non-UK trust fund, only one of which was held by a UK-resident.

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[252] [1897] AC 21.

[253] *Lord Sudeley v Attorney-General* did not in fact provide especially strong support for the Court of Appeal position. In particular, the estate in that case was not fully administered so the residual assets net of liabilities were not fully ascertained. This differed from the fully constituted trust in *Baker v Archer-Shee.* Even if the estate had been fully administered, the relevant beneficiary was only entitled to a quarter of the entire residue, so until assets were appropriated to satisfy that quarter share, one could not know what assets it would contain. This point was made by Lords Shand and Davey at [1897] AC 11 at 20-22. It is not relevant to *Baker v Archer-Shee* where Lady Archer-Shee was the sole life interest holder in the entire fully-constituted trust fund.

[254] [1981] STC 784 at 797.

[255] 7 TC 387.

[256] In "The Archer-Shee Cases (1927) Trusts, Transparency and Source", Chapter 6, Landmark Cases in Revenue Law ed. John Snape and Dominic de Cogan, Hart 2019, 139 at 149, Malcolm Gammie QC notes that from a UK income tax perspective, a life interest in a UK trust renders the trust transparent because under English trust law, the income beneficiary has an immediate entitlement to trust income. One can therefore look at the underlying trust assets and income for the purposes of a tax assessment. That is also true where non-UK trust law is to the same effect. In such cases, the trust disappears as a separate "source" of income for tax purposes.

[257] 11 TC 749 at 771-2.

The further twists and turns of the *Archer-Shee* litigation are discussed below.[258] However, it is important to note that a similar point had already been considered by the Judicial Committee of the Privy Council in *Syme v Commissioner of Taxes*[259]. *Syme* was not cited in *Baker,* even though the judgment in that case had been given by the then Lord Sumner[260]. In *Syme,* the taxpayer was a life interest holder in a trust where the trustees owned and ran certain active businesses. The question was whether the life interest holder was entitled, under the relevant tax rules, to a lower tax rate in respect of his share of this trust income on the basis that it was derived from "personal exertion", even though the life interest holder did not conduct the relevant businesses. The Privy Council found in favour of the life interest holder. "Income derived from personal exertion" was not defined so as to exclude this situation. In particular, there was an underlying active business in Victoria which generated the income and that active business was carried on by trustees for the benefit of the taxpayer and others. Furthermore, both the Australian trustees and the life interest holder were taxable in respect of the **same** income. As Lord Sumner expressed it:

> "What was the produce of personal exertion in the trustees' hands till they part with it does not, in the instant of transfer, suffer a change, and become the produce of property and not of personal exertion, as it passes to the hands of the cestui que trust [i.e. the beneficiary]"[261]

Syme itself does not appear to have been influenced by any anti-avoidance issues and the court did not allude to the importance of the governing law of the trust. *Syme* has been followed in Canadian cases involving the taxation of life interest holders[262].

4.3.3.2 The later Archer-Shee litigation and its implications

Undaunted by defeat in the House of Lords, the Archer-Shees raised a new argument when they were refused the remittance basis. In particular, they produced expert evidence of New York trust law.

[258] In the words of author of the article referred to in fn 248, this litigation "must be the longest running dispute in the history of tax, requiring two hearings in the House of Lords, three in the Court of Appeal, and four each in the High Court and the Special Commissioners to determine whether the life tenant of a trust receiving underlying income from securities, stocks, shares or rent received the same type of income as the underlying income, which meant that the remittance basis no longer applied, or a different type of income, trust income, from which the remittance basis had not been taken away." Yet to this day not all judges have grasped this distinction: in *Ardmore Construction Ltd and another v HMRC* 18 ITLR 291 at 303, the Upper Tribunal (Tax and Chancery) said that "[The Archer-Shee cases] **did not concern source** [emphasis added], but the question of entitlement to income under a will trust created by a US testator, which turned on the nature of the interest under the trust as ascertained by reference to the foreign law of the trust." With respect, this misses the key point that the nature of the interest in the trust determined whether the "source" of Lady Archer-Shee's income, for tax purposes, was "stocks, shares or rents". The Archer-Shee cases were not considered by the Court of Appeal when dismissing an appeal from the Upper Tribunal decision in *Ardmore*: see 20 ITLR 874.

[259] [1914] AC 1013, an appeal from the Supreme Court of Victoria in Australia.

[260] It was briefly cited and distinguished somewhat unconvincingly in the later *Archer-Shee* litigation: see 4.3.3.2.

[261] [1914] AC 1013 at 1021. Lord Sumner was also one of the judges in *Drummond v Collins* 8 TC 525, where he delivered a one-line judgment concurring, in particular, with Lord Wrenbury who strongly suggested that the "source" of a life interest holder's taxable income was the underlying non-UK trust fund: see fn 149 above.

[262] *Gilhooly v Minister of National Revenue* [1945] Ex. C.R. 141 and *Kemp v Minister of National Revenue* [1947] Ex. C.R. 578. See also Avery Jones: Trusts op. cit. at page 384 fns 44 and 45. *Syme* was distinguished by the Court of Session in *Fry (Surveyor of Taxes) v Shiel's Trustees* 6 TC 583. In that case, the question was whether the beneficiaries were entitled to a reduced rate of income tax on "earned income" from a trade held by trustees for their benefit. The UK Finance Act 1907 only conferred a reduced rate on income "immediately derived by the individual from the carrying on or exercise by him of his profession, trade or vocation". This test was more stringent than the test in the Australian legislation in *Syme* which simply required the income to be "derived from personal exertion", without further requiring that exertion to be the beneficiary's, not the trustee's.

Initially, they sought to raise this new argument in relation to the tax years which had already been the subject of litigation in *Baker.* However, a majority of the Court of Appeal[263] ruled against them on the basis that, following the House of Lords' decision in *Baker,* the nature of the interest in the New York trust was "res judicata".

They then raised this new argument again when the then Inland Revenue assessed them for later years. Initially, the Inland Revenue argued that *Baker* rendered the matter "res judicata" for those later years too. However, they then dropped this point and the appeal proceeded, on the basis of the new argument. A majority of the Court of Appeal[264] ruled that the nature of the life interest in a trust governed by New York law was not sufficiently different from the English law position so as to alter the outcome compared to *Baker.* However, the taxpayers then succeeded in their 1930 appeal to the House or Lords in *Garland v Archer-Shee*[265]. In essence, the court ruled that once the evidence of New York law was taken into account, the position was in fact as set out by Viscount Sumner in his dissent in *Baker v Archer-Shee.*[266] As Lord Tomlin put it[267]:

> "The evidence upon American law…contains statements to the effect that the whole estate …in the trust funds is vested in the trustees and that the words of the trust give to [Lady Archer-Shee] merely the right to resort to a Court of equity to compel the trustees to discharge the task imposed upon them which was to apply the money which they receive as a net income from the trust to her use, that they have, within the limits of reasonable and conscientious behaviour, an absolute discretion as to the application of the income for her benefit, that if they decided to apply

[263] In *Archer-Shee v Baker (Inspector of Taxes)* 15 TC 1. That second case stemmed from the order of the House of Lords to the Special Commissioners to give effect to their decision in *Baker,* and in particular to identify which of the trust's investments were "securities" or "stocks, shares or rents" for the purposes of Schedule D Cases IV and V. Income from any such assets would not be eligible for the remittance basis. The Commissioners' breakdown of the trust's investments is at 15 TC 1 at 4-6.

[264] In this respect the Court of Appeal disagreed with Rowlatt J. Lawrence LJ in particular said, at 15 TC 693 at 721-2, that American law was like English law in that a life interest holder in a trust of personalty (e.g. securities) had no legal or beneficial interest in the corpus of trust assets. Furthermore, any extra discretion of the trustee under American law regarding when and how to apply income for the benefit of the life interest holder was immaterial: "The whole of the net income must ultimately be either paid over to or applied for the benefit of Lady Archer-Shee….thus showing conclusively that she has a right of property in the income and not merely a personal right against the trustee. Further the trustee cannot unreasonably or indefinitely withhold the payment or application of the income…."

[265] 15 TC 693 at 729.

[266] 11 TC 749. In "The Archer-Shee Cases" op. cit., Malcolm Gammie QC states that, in *Garland v Archer-Shee,* the taxpayer's case depended on showing that the trust changed the character of what Lady Archer-Shee received and that in particular she "received the income not as a matter of entitlement pursuant to her interest under the trust but as a result of the trustee's decision to exercise some discretion to pay her the income". This is not meant to suggest that under New York law, the trust was a discretionary trust: Lady Archer-Shee retained a fully vested life interest in the trust fund. It means only that under a *Garland*-type trust, the rights of the life interest holder are simply the right to have income paid over to, or applied for the benefit of, the life interest holder, with the trustees having some discretion regarding the manner and time of doing so. The author disagrees with the following statement in Hudson: "Equity and Trusts" (9th edition – 2017) at page 158: "Lady Archer-Shee was the only life tenant, having an interest in possession, under her father's residuary estate with no other potential beneficiary in existence. Consequently, it was held that Lady Archer-Shee would have been entitled under the principle in *Saunders v Vautier* to have directed the trustees to deal with the trust property. Equally, Lady Archer-Shee was taxable on the income from the trust as though she was its absolute owner because this income was effectively held on bare trust for her". There was no suggestion that Lady Archer-Shee had more than a life interest in the trust income or that she could call upon the trustees to transfer the trust capital to her. Otherwise Viscount Sumner's dissenting judgment would have made no sense. Rather the case focussed instead on the true "source", for income tax purposes, of Lady Archer-Shee's trust income.

[267] 15 TC 693 at 735-6.

the money for her benefit instead of paying it over they must exercise the power to do so reasonably, and that she had no right to any specific dividends or interest at all.

In the face of these statements, I think the finding of fact must necessarily be that, according to American law, [Lady Archer-Shee] has no property interest in the income arising from the securities, stocks and shares constituting the trust fund but has only a chose in action available against the trustees. …the assessable income…..is income arising from a possession out of the United Kingdom other than stocks, shares or rents, viz., a chose in action available against the American trustees [and hence eligible for the 'remittance' basis]".

Doubt has been expressed about the accuracy of the expert evidence in respect of New York law on which this finding of fact was based[268]. That evidence[269] was that Lady Archer-Shee "had no right to any specific dividends or interest at all"; and that "whilst…the whole of the net income…..must ultimately be paid over to or be applied for the benefit of Lady Archer-Shee, the manner and times of doing so were within the discretion of the trustees subject to judicial supervision". Nevertheless the relevance of the governing law of the trust, and how it analyses a life interest in that trust, is now firmly established. In *Kelly v Rogers*[270], there was evidence that under the law of New Jersey, which applied to the trust in that case, the income entitlement of the beneficiary in that case was to such a sum as was required for her maintenance: she had no right to the income of any specific stocks and shares but only the right to require the trustee to administer the trust reasonably[271].

The extent to which the governing law of the trust determines the UK tax position is not unlimited. It will be key in deciding the nature of the beneficiary's interest but it will then be a question for UK tax law whether that interest gives rise to income or capital receipts for tax purposes. Thus in *Lawson v Rolfe,*[272]it was agreed that the taxpayer had a life interest in a trust governed by the law of California which entitled her to the proceeds of specific shares in US companies. Her entitlement was not just a *Garland* right to have the trustees administer the trust properly. The underlying companies proceeded to issue bonus shares (or "stock dividends") to which the taxpayer, as holder of the life interest, was entitled under the governing law of the trust. She was assessed to UK income tax on these "stock dividends". Foster J agreed with the taxpayer that the "stock dividends" were in fact capital, not income, for UK tax purposes. The judge said[273]:

"Under Californian law the nature of Mrs Lawson's interest is that she is entitled to the income of her share and to bonus shares of a certain nature. But the court must then consider whether those bonus shares when issued have the character of capital or income in accordance with the law of England. In English law it was decided…..that shares credited to a shareholder in respect of a bonus being distributed by the company as capital were not income in the hands of that shareholder"[274].

[268] The findings of fact of the Special Commissioners regarding New York trust law are set out at 15 TC 693 at 696-9, where two experts are quoted. Doubts about the expert evidence are raised in the article referred to at fn 248 above and, in particular, the citation from Scott on Trusts (4th ed.) in footnote 150 of that article. See also Avery Jones: Trusts op. cit. page 384 at fn 46. In "The Archer-Shee cases" op. cit., Malcolm Gammie QC is more hesistant about whether the expert evidence was flawed: see fn 44 at page 154 of that article.
[269] See 15 TC 693 at 732.
[270] 19 TC 692.
[271] The Court of Appeal in *Kelly v Rogers* also approved the statements of Lord President Clyde in the Court of Session in *Reid's Trustees v the Commissioners of Inland Revenue* 14 TC 512 which were cited in 4.3.3.1 above.
[272] [1970] 1 All ER 761.
[273] [1970] 1 All ER 761 at 767.
[274] Foster J went on to rule that even though there had been a number of stock dividends, this did not amount to a separate source of income in the form of a "series of recurrent payments over a substantial period of time". See also *Stevenson v Wishart* [1986] STC 74 and [1987] STC 266.

In *Inland Revenue v Clark's Trustees*[275], the Court of Session, in an estate duty case, ruled that Scottish law differed from English law, as determined in *Baker v Archer-Shee*[276]. Lord President Normand stated[277]:

> "[In *Baker v Archer-Shee*], Rowlatt J ….said 'What this lady enjoys is not the stocks, shares and rents or other property constituting the trust fund under the will; what she has is the right to call upon the trustees to administer this property during her life so as to give her the income arising therefrom according to the provisions of the trust. Her interest is merely an equitable one, and it is not an interest in specific stocks and shares constituting the trust fund.' In my opinion that is a very accurate description of the rights of a beneficiary enjoying a life rent under a Scottish trust deed, and……it is a very good description of what was proved to be the law of the State of New York in the second *Archer-Shee* case."

In the same case, Lord Moncrieff said (at page 6):

> "In my view, the right of property in the estate of the trust is vested in the trustees to the exclusion of any competing property, and the right of the beneficiary, exactly as is here said to be the right of the beneficiary under the law of New York, is merely a right *in personam* against the trustees to enforce their performance of the trust. It is true that in the assertion of that right a beneficiary will in certain cases obtain the aid of the Court to enable him to use the names of the trustees, but it is only as representing the trustees in such a case that he can attach or assert any property right over the assets of the trust".

This statement reflects important differences between the Scottish and English law of trusts, reflecting the civil law foundations of Scottish law. One recent commentator has described the Scottish trust concept as follows:

> "Equity is absent from Scots law and under Scots law, separate rights of ownership cannot exist concurrently in the same property. Comparable concepts of 'rights' are used in matters of ownership of property and trusts. …In a Scottish trust, the trustees are absolute owners of the trust property, and so have a **real right** to that property, and to hold and defend title to it from third parties. The beneficiaries in turn then have a **personal right** against the trustees for implementation and fulfilment of their duties as trustees to the beneficiaries. This right of the beneficiaries is therefore enforceable against the trustees, not against the specific trust property. Scots law then applies a concept of 'dual patrimony' to deal with the separation of ownership of the trust property by the trustees, and the ownership of the trustees' own personal property…[emphasis added]"[278].

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[275] 1939 Scots Law Times 2.
[276] 11 TC 749.
[277] 1939 Scots Law Times 5.
[278] Fiona Clarke: "One Island, Two Systems: the divergence of trust law in Scotland v England and Wales". Trust Quarterly Review, Volume 17, Issue 2, 2019, pages 5-10 and in particular, at page 6. The "dual patrimony" concept has significant practical implications e.g. it protects trust assets from the trustee's personal creditors but it also prevents the creation of a floating charge over property held under a Scottish trust by a company - see Alisdair D.J. MacPherson: "Floating Charges and Trust Property in Scots Law: A Tale of Two Patrimonies" Edinburgh Law Review 22.1 (2018) at pages 1-28. For detailed discussion of "dual patrimony", see George Gretton: "Trust without Equity" (2000) 49 International and Comparative Law Quarterly at pages 599-620, where the author accepts that there is ongoing uncertainty about the nature of a Scottish trust. That uncertainty was also raised by Lord Hope in *Re Lehman Brothers International (Europe) (a company)(in administration) and another* [2012] 3 All ER 1 at 7-9. In particular, he noted: "There are significant differences

The Scottish law position has in fact now been altered for income tax purposes by statute, so as to align it with English law as per *Baker v Archer-Shee*[279]. HMRC have set out in their published guidance[280] a list identifying which jurisdictions do and do not characterise a life interest in the same manner as in *Baker v Archer-Shee.* Most Commonwealth jurisdictions follow the approach under English law as set out in *Baker* but others (e.g. India, Quebec, South Africa) apparently characterise a life interest as in *Garland v Archer-Shee*[281]. The same is true of certain states of the United States, such as New York, although apparently most US states follow the approach in *Baker*[282].

The fact that the trustees of a trust with a life interest are also required to pay an annuity out of the trust income does not prevent *Baker v Archer-Shee* from applying when the trust is governed by English law[283].

The rule in *Baker v Archer-Shee* may treat the holder of a life interest as entitled for tax purposes to income directly from the underlying assets of the trust. To that extent, it leads to a form of income tax "transparency". However, it is a more qualified form of "transparency" than that to which Section 60 TCGA (supra) gives effect for capital gains tax purposes[284]. This is evident in relation to the treatment of trust expenses, where it is clear that the trust is not simply disregarded. Where the trustees legitimately incur trust expenses or pay tax which in either case is chargeable against the income of the trust, then those are expenses of the trust which reduce the **amount** of the income

between English and Scots law as to [the trust's] nature and origin. For example, the law of Scotland does not accept that a relationship in trust can arise in equity. It has a more limited basis. Its origin can be traced back to the law of mandate or commission, which is part of the law of obligations: Stair *Institutes of the Law of Scotland* (1693) I.12.17. Various attempts have been made to explain the basis for the concept. They have not been successful, as its nature is considered to be of too anomalous a character to admit of a precise definition. But it can at least be said that the duty that the trustee owes to the beneficiary is fiduciary in character….."

279 See Section 464 ITA (formerly Section 118 Finance Act 1993). The 1993 changes were introduced in order to enable the life renter of a Scottish trust, like the life tenant of an English trust, to benefit from the lower rate of tax applied from 1993 initially to dividend income and from 1996 to all savings income: see also the article referred to at fn 248 above.

280 At paragraph TSEM10423 of the Trusts, Settlements and Estates Manual (accessed 10 June 2020).

281 15 TC 693. Like Scotland, both Quebec and South Africa have legal systems with deep roots in civil law (respectively, pre-1789 French law and pre-1800 Roman-Dutch law) but have nevertheless developed their own concept of the trust. For a comparison of the Scottish and South African conceptions of trust, see Honore op. cit. at 793-818. It is not surprising that a life interest in a South African trust falls within *Garland v Archer-Shee* because a South African trustee will typically be the sole owner of the trust property for the purposes of administering it while a trust beneficiary will not have a "ius in rem" in that property. It will only have a "ius in personam" against the trustee requiring it to enforce the trust: for a much fuller exposition, see Francois du Toit: "The South African Trust in the Begriffshimmel? Language, Translation and Taxonomy". Rabels Zeitschrift fuer auslaendisches und internationales Privatrecht. Max-Planck Institute. October 2015 at 852, and especially at fn 110. Quebec introduced its own statute-based trust law in 1994. It goes further than South African and Scottish trust law because the property of a Quebec trust is a separate patrimony in which none of the settlor, the trustee nor the beneficiary has a proprietary right. The trustee's role is therefore purely administrative. Hence, a Quebec trust seems quite similar to a civil law foundation: see 4.1.2 and also George Gretton: "Trusts without Equity" op. cit. at page 616. For further discussion of the trust concept in civil law jurisdictions and those with a "mixed" civil law and common law heritage, see Donovan W.M. Waters QC: "The Concept called 'the Trust'" (March 1999) Bulletin of the International Bureau of Fiscal Documentation 118, and especially at 118-122.

282 For the reasons discussed above, there are doubts about HMRC's position regarding the law of New York.

283 *Nelson v Adamson* [1941] 2 All ER Annotated 44.

284 Or indeed the transparency which would have arisen if the New York trustees, like the UK trustees in *Williams v Singer* 7 TC 387, had simply mandated payment of the underlying investment income directly to Lady Archer-Shee.

entitlement of the life interest holder (i.e. it is a net entitlement) even if they do not alter the underlying source(s) for tax purposes of that income entitlement. Those expenses are not treated as incurred by the life interest holder, who is not regarded as entitled to the gross income of the trust before those expenses are deducted. This is clear from two decisions of the Court of Session[285]. In both cases, a life interest holder argued that trust income applied by the trustees in meeting trust expenses, after paying income tax on it, was nevertheless income to which that beneficiary was entitled. If correct, the beneficiary would have been entitled to recover tax paid by the trustees on the income which they used to meet those expenses. The Court in each case rejected the argument of the life interest holder[286]. The latter's interest is no greater than the amount the beneficiary is entitled to receive net of expenses of the trustees. Hence tax paid by the trustees on the trust income used to meet those expenses is not recoverable by the beneficiary, although that tax may be at a lower rate (20%) than the beneficiary's marginal income tax rate. The (reduced) amount to which the beneficiary is entitled must be grossed up where relevant by any tax paid by the trustees in respect of the amount to which the beneficiary is entitled. The trustee-level tax referable to that amount may then be creditable/recoverable by the beneficiary[287].

It is also doubtful that the rule in *Baker v Archer-Shee* enables a life interest holder to claim tax losses in respect of income-generating activity carried on by the trust. The rule is merely one identifying the source of a taxpayer's income. If the activity which potentially generates that income in fact produces a loss (e.g. where the trust conducts a loss-making trade), the life interest holder cannot claim its share of that loss for the purposes of setting it against other income as "sideways relief" because (unlike the trustees) it does not "carry on" that trade, as required by Sections 61(1) and 64(1)(a) ITA. This can be contrasted with the much more comprehensive tax "transparency" which exists in relation to a trading partnership. A partner's income source is the underlying income of the partnership. If the partnership trades at a loss, the partner is entitled to claim its share of that loss and set it against other income[288], precisely because the partner itself is treated as carrying on the single partnership trade by being a member of the partnership. As Vinelott J expressed it in *MacKinlay v Arthur Young McLelland Moores & Co*[289]:

> "What has to be ascertained is the profits of the firm and not of the individual partners. That is not, I think, stated anywhere in the Income Tax Acts but it follows necessarily from the fact that there is only one business and not a number of different businesses carried on by each of the partners".

[285] *Murray v Commissioners of Inland Revenue* 11 TC 133 and *Macfarlane v Commissioners of Inland Revenue* 14 TC 532, which fell chronologically either side of the House of Lords' decision in *Baker v Archer-Shee.*

[286] It noted that in *Baker v Archer-Shee,* the Crown had conceded that the life interest holder was not taxable on trust income applied by the New York trustees in duly meeting trust expenses. For a possible explanation of this concession, see Malcolm Gammie QC: "The Archer-Shee Cases" (op. cit.) fn 41 at 152-3.

[287] Chapter 8 Part 9 ITA now sets out in some detail these rules regarding the impact of trust expenses on the amount of the life interest holder's income entitlement. These rules also apply if the holder of the income entitlement is subject to corporation tax: see Section 611 CTA 2010. For a good numerical example of how these rules work, see Example 18.6 in Fairpo and Salter: "Revenue Law: Principles and Practice" 37th edition, Bloomsbury Professional at page 558.

[288] See Sections 62, 64 and 65 ITA and subject to the general restrictions on "sideways relief" (e.g. Sections 66-70 ITA).

[289] [1986] STC 491 at 504-5. These dicta were approved by the House of Lords on appeal in [1989] STC 898 at 901. While the method of assessing income tax on partners in a partnership has changed since the 1980's, this does not affect the accuracy of this statement. Furthermore, as the House of Lords made clear (reversing the Court of Appeal) this statement applies whether the partnership is small or (as in *MacKinlay* itself) large, so that each partner is no more than one among many.

The rule in *Baker v Archer-Shee* has been expressed to be a rule of English trust law, not of English tax law[290]. This has several consequences. The first is that the impact of the rule is very much dictated by the governing law of the relevant trust. This is so even though the rule primarily decides the source, for UK tax purposes, of the life interest holder's income: the life interest itself or the income-producing assets which underlie it? It is strange, and unsatisfactory as a matter of tax policy, that the UK income tax treatment of a life interest can be varied simply by setting up a trust with the "right" governing law[291]. Yet this can have important practical implications. For example, in the UK "offshore fund" rules, it can be important to decide whether a UK-resident holds an interest in a "transparent fund"[292]. If (as is typical) that fund is structured as a non-UK trust, then it cannot be a "transparent fund" unless the governing law is consistent with English trust law as described in *Baker v Archer-Shee*[293].

Secondly, even as a rule of trust law, the rule in *Baker v Archer-Shee* is not easy to understand. It purports to contrast the case where the life interest holder is entitled to underlying trust income (net of expenses) as it arises with the case where the life interest holder is simply entitled to have the trust fund properly administered and the aggregate net income paid over to it or applied for its benefit. Yet this does not seem to be a real distinction[294] because the second situation is surely present in all life interest trusts. In such trusts, unlike bare trusts, the life interest holder has no entitlement to any of the underlying capital of the trust fund. Surely **any** holder of a life interest is only entitled to have the trust fund properly administered and the aggregate income paid to it or applied for its benefit, whatever the governing law of the trust? The distinction being drawn seems to be between cases where the trustees do, and where they do not have the right to apply income for the benefit of the life interest holder (rather than paying it to that person directly). This seems an immaterial distinction, which is what the majority of the Court of Appeal decided in *Garland v Archer-Shee*. This author has considerable sympathy for their approach. Whether and how income is taxable should not depend on a fine semantic distinction which can be easily manipulated by choosing the "right" governing law for the trust.

The real question is whether all life interest holders should, despite the precise rights and powers of the trustees, **also** be regarded as entitled to underlying trust income as it arises so that each trust asset is, for UK tax purposes, a separate source of income when taxing that life interest holder. That should be a question of UK tax policy with a uniform answer for all life interest holders. There is much to be said for subjecting all life interest holders to the rule in *Baker v Archer-Shee*, whose underlying premise is that the source of income should not change simply by interposing a life interest trust. The

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[290] Hence the importance of the governing law of the trust when deciding if that rule applies or not.

[291] Interestingly, the decision of the Privy Council in *Syme* [1914] AC 1083, which was a forerunner of *Baker v Archer-Shee,* makes no reference to the significance of the governing law of the trust.

[292] In such a case, the UK-resident can avoid a number of disadvantages under the rules: see Regulation 29 Offshore Fund (Tax) Regulations 2009 SI 2009/3001.

[293] See the definition of a "transparent fund" in Regulation 11 Offshore Fund (Tax) Regulations 2009 SI 2009/3001, and in particular Regulation 11(a). The same approach applies in paragraph 8 Schedule 5AA TCGA: this determines if an income tax-"transparent", "UK property-rich" "offshore collective investment vehicle" can elect, with investors' consent, to be treated as a partnership for the purposes of taxing non-UK-residents on chargeable gains from direct or indirect investment in UK real property. This election is targeted at trust-based collective investment vehicles, which would otherwise be treated as a company, and their unitholders as shareholders, under Schedule 5AAA. For a more detailed discussion, see Sarah Squires: "Finance Act 2019 notes: section 13: disposals by non-UK residents etc: and Schedule 1, paragraph 21: Schedule 5AAA to the Taxation of Chargeable Gains Act 1992 – UK property rich collective investment vehicles, etc" [2019] BTR 278 at 285-7.

[294] It is not easy to explain this elusive distinction to non-UK lawyers in order to obtain local law advice on the nature of a life interest in a non-English law trust.

author's view is that the House of Lords in *Garland v Archer-Shee* took a wrong turn when it reversed the Court of Appeal.

That wrong turn is further illustrated by the potential impact of *Garland v Archer-Shee* in cases like *Williams v Singer* (see 4.3.3.1). Suppose that non-UK-source income is received by UK-resident trustees of a trust with a non-UK-resident life interest holder. The trust's governing law does not treat the life interest holder as entitled to underlying trust income. Therefore, the effect of *Garland v Archer-Shee* seems to be that the trustees cannot avoid a 20% UK tax charge even though the trust income is non-UK-source and the life interest holder is non-UK-resident. Because the life interest holder is not entitled to underlying income but only to a distribution of net trust income, the source of that income is its rights to enforce the UK-resident trust and not the underlying income. Hence the holder cannot argue that an income tax charge at trustee level would (as in *Williams v Singer)* tax a non-UK-resident on non-UK-source income. If this is the effect of *Garland v Archer-Shee,* it highlights its flaws: minor technical differences in the trust's governing law about the nature of a life interest mean that the UK tax charge on trustees can now have extraterritorial effect, contrary to *Williams v Singer*. Furthermore, the life interest holder is worse off than a non-UK-resident discretionary beneficiary of a UK-resident trust which distributes non-UK-source income, who can rely on ESC B18 (see 4.3.5) to recover UK tax at trustee level on that income. The courts may in fact decline to apply *Garland v Archer-Shee* in this way. In *Kelly v Rogers* (see 4.3.3.1), Romer LJ indicated (obiter at 19 TC 713) that if the income beneficiary had been non-UK-resident, then the UK-resident trustees would not have been taxable on the trust's non-UK-source income. In that case (which postdated both *Williams v Singer* and the *Archer-Shee* litigation), the trust's governing law meant that the UK-resident income beneficiary had no entitlement to specific underlying trust income. At a minimum, the rule in *Baker v Archer-Shee* should be confined to cases where there is a prima facie UK income tax liability, either because there is UK-source trust income or the holder of the vested income interest is UK-resident. Hence, *Garland v Archer-Shee* would never apply to the extent that non-UK-source trust income was to be applied for the benefit of a non-UK-resident life interest holder.

Thirdly, formulating the rule in *Baker v Archer-Shee* as a rule of trust law means that it does not catch all income of the life interest holder for UK tax purposes. There are a number of items which constitute "income" for tax purposes which do not amount to "income" under trust law. Such items cannot be treated as income of a life interest holder under the rule in *Baker v Archer-Shee.* In one respect this makes sense: the life interest holder would not be entitled to require the trustees to pay it these amounts because they are not "income" under trust law. Therefore, it should not be taxed as if it is entitled to them as they arise. However, because these items are "income" for tax purposes but not under trust law, then to that extent the trust is not "transparent". Some such items may be taxed as income at the level of the trustee alone, under Section 481 ITA (see 4.3.5). Good[295] examples of items which are "income" for tax purposes, but not for trust purposes, arise under the "short lease premium" rules and the rules taxing accrued income on debt securities. The former[296] tax as income part of the premium paid for the grant of certain shorter leases even though any such premium (unlike rent) is typically regarded for trust law purposes as a capital receipt when granting a lease. The accrued income rules[297] bring into the income tax charge that element of the sale price of a debt security which represents accrued but unpaid interest. For trust law purposes, that "cum div" element

[295] These examples are by no means exhaustive.
[296] Chapter 4 Part 3 ITTOIA and Chapter 4 Part 4 CTA 2009.
[297] Part 12 ITA. For corporation tax, an equivalent effect is achieved via the "loan relationships" code in Parts 5 and 6 CTA 2009.

of the sale price of the security would be treated simply as part of its capital value (unlike the actual receipt of interest on an interest payment date)[298].

Fourthly, it appears that HMRC practice somewhat mitigates this aspect of the rule in *Baker v Archer-Shee.* In particular[299], where the trustees of a life interest trust carry on a taxable trade which would entitle them to claim capital (i.e. depreciation) allowances on the non-circulating assets of that trade, HMRC allow the life interest holder to claim those capital allowances and take them into account in computing its income from the trust. This is sensible, not least because it should ensure that the life interest holder's taxable income can be no greater than that of the trustees. However, this answer is not easy to reconcile with the rule in *Baker v Archer-Shee.* Where that rule applies in respect of a trading trust[300], it simply treats underlying trust income (as defined under trust law principles) as the source of the life interest holder's income. Yet capital allowances are a standalone form of tax depreciation only. They are not the same as commercial depreciation based on accounting principles, which may already be reflected in the trust law definition of income. Capital allowances are a separate tax relief and are not automatically built into the concept of the income of a trade, for tax or trust law purposes[301].

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298 In the past, trust law and income tax law were aligned in this respect: see *Wigmore v Thomas Summerson & Sons Ltd* 9 TC 577. Accrued income profits will be taxed on the trustees at the special rates of income tax discussed at 4.3.5 (see Sections 481-2 ITA 2007) unless the trust is equivalent to one within Section 60 TCGA. In that case, the trust is transparent in much the same way as a trust within Section 60 (see Section 666 ITA). Where a debt security is bought with accrued interest ("cum div"), the element of the purchase price representing accrued interest is offset against interest payable on the next interest payment date. The person entitled to that interest gets tax relief accordingly. If *Baker v Archer-Shee* applies, that person will be the life interest holder who thereby gets tax relief for an amount which, under trust law principles, is probably part of the capital cost of the security.

299 See TSEM3772 in the Trusts Settlements and Estates Manual (accessed 10 June 2020).

300 Questions have been raised about whether the rule in *Baker v Archer-Shee* can apply to a life interest in a trust which is carrying on an active trade. This point arose (without being decided) in judicial review proceedings regarding retrospective tax legislation: see Kenneth Parker J in *R on the application of Robert Huitson v HMRC* [2010] EWHC 97 (Admin) and, in particular, paragraphs 52-3. In that case, *Baker v Archer-Shee* was being relied on as part of a tax avoidance scheme involving a claim for treaty protection in respect of the profits of an Isle of Man partnership in which the UK-resident taxpayer invested via a life interest trust. There were other purposive arguments on treaty interpretation which could have been deployed by HMRC anyway. Moreover, the court in *Huitson* was not referred to *Syme v Commissioner of Taxes* [1914] AC 1013, discussed at 4.3.3.1. In that case the court did apply to an "active" trust a principle very similar to the rule in *Baker v Archer-Shee.* Although a decision of the Privy Council, *Syme* is certainly very persuasive authority on the point. For this reason, the author doubts the correctness of the statement in Tiley's Revenue Law (9th edition), at page 635, fn 56, that an "active trust" is not subject to the rule in *Baker v Archer-Shee.* Indeed, when corporation tax rates were higher than basic rate income tax pre-1984, trading trusts (rather than private limited companies) were in fact set up to take advantage of *Baker*. The vested income beneficiaries would be the grandchildren of the settlor (thereby avoiding trust income attribution to the "settlor"); the trustees would only be taxed at the basic rate of income tax; and the beneficiaries could potentially use their own tax reliefs to recover some or all of the tax paid by the trustees. For a discussion of how a trading trust could still be used to limit UK tax to 20% on profits from trading in UK land, see Patrick Soares: "Using Family Trading Trusts for Land Deals – Stopping Tax at the Basic Rate" (2008) Gray's Inn Tax Chambers Review. Volume VII, No 2.

301 Capital allowances are regulated by the Capital Allowances Act 2001. Under the HMRC practice described in the main text, if the life interest holder can claim capital allowances, then presumably the trust income must be increased to exclude any commercial depreciation already reflected in that income for trust law purposes. Otherwise, the life interest holder's taxable income would be reduced by both capital allowances and commercial depreciation! HMRC practice seems generous to the life interest holder in further respects. In particular, if capital allowances are claimed in respect of an asset used by trustees in a trade but that asset is later sold for more than its tax-written-down value, the excess over that value may be clawed back as income for tax purposes. That clawback, however, is not income for trust law purposes. Trust law typically sees the

Therefore overall, the rule in *Baker v Archer-Shee,* when applicable, offers a life interest holder a degree of income tax "transparency". The life interest holder should therefore be entitled to any special rates of taxation applicable to the underlying trust income (e.g. lower rates of tax in dividends). Furthermore, if that income has been subject at source to non-UK taxation, the life interest holder should much be better placed to claim double taxation relief e.g. by way of credit. However, this form of "transparency" is by no means complete, in contrast to the position applying to "bare trusts". The rule is also idiosyncratic, not least because when it applies is dictated (at least in part) by the governing law of the relevant trust. These idiosyncracies have further knock-on effects when applying double tax treaties, as discussed in 6.8.6.

4.3.4 Trusts with a vested interest in possession: capital gains tax

For capital gains tax purposes, there is no equivalent of the rule in *Baker v Archer-Shee.* Where a trust does not fall within Section 60 TCGA, then the trust property will be "settled property" for capital gains tax purposes[302]. The trustees will be treated as a separate and continuing person distinct from the persons who are trustees from time to time[303]. Where that separate person is UK-resident[304], then that person is potentially subject to capital gains tax at normal capital gains tax rates in its own right[305].

Some "interest in possession" trusts (because of the identity of the particular beneficiary) are eligible to pay tax on gains in respect of certain business assets owned by the trust at only 10%, because of "entrepreneurs' relief"[306]. Likewise, certain "interest in possession" trusts can benefit from "investors' relief" on disposing of shares[307]. That relief is a preferential 10% rate of capital gains tax when certain non-listed shareholdings are disposed of. Other types of trust (e.g. a discretionary trust) cannot benefit from either of those reliefs.

Therefore a trust which falls outside Section 60 TCGA is in principle "opaque" for capital gains tax purposes, whether or not there is a vested interest in possession. This is also true if the trust is non-UK-resident under the rules in Section 69 TCGA. A transfer of assets to the trust will therefore be an outright disposal of the entire property being settled, even if the settlor is a trustee and/or has a beneficial interest under the trust[308]. Generally, a transfer of an asset from the trust to a beneficiary will, if the trust is UK-resident, trigger a deemed disposal and reacquisition of that asset by the trustees at open market value[309]. If that results in a gain, the tax is a liability of the trust which cannot

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clawback amount as part of the disposal price of a capital asset of the trust. Because that amount is not trust income, the life interest holder should not be taxed on it even though it represents capital allowances already claimed by the life interest holder in reducing its taxable income from the trust.

[302] Section 68 TCGA.

[303] Section 69 TCGA.

[304] Under the rules in Section 69(2A) to (2E) TCGA. Rates of tax are currently 28% for capital gains in respect of, in particular, residential property and 20% in respect of almost all other capital gains. Because a UK-resident trust is now subject to capital gains tax at full marginal rates, the rules which used to attribute trust gains to a UK-resident settlor were abolished in 2008 in relation to UK-resident trusts. This further reduces the effective "transparency" of such trusts for the purposes of capital gains tax.

[305] Unlike the situation which pertains when Section 60 TCGA applies.

[306] See Chapter 3 Part V TCGA and in particular Section 169J TCGA. The relevant "interest in possession" must not be for a fixed term.

[307] See Chapter 5 Part V TCGA and in particular Section 169VH TCGA. Again, the relevant "interest in possession" must not be for a fixed term.

[308] Section 70 TCGA.

[309] Section 71(1) TCGA. The beneficiary then acquires the asset at open market value.

be sheltered with reliefs (e.g. losses) available to the beneficiary. If it results in a loss, there is limited scope[310] for the beneficiary to inherit and use those losses, provided they cannot be used by the trustees. In some cases, there may be scope for trustees to transfer a chargeable asset to a beneficiary without triggering gain if a "hold-over" relief claim is made. In that case, the beneficiary acquires the asset at the historic base cost of the trustees[311].

This "opaque" tax treatment of the trust can mean that the UK tax burden in respect of capital gains is higher if those assets are held in a UK-resident trust than if they are held directly by the UK-taxpaying beneficiaries. While the tax system should not encourage the use of trusts as a means of tax avoidance, making it detrimental tax-wise to put assets into a trust seems a step too far, given that a trust is above all an asset protection mechanism, for the benefit of its beneficiaries.

Because trusts outwith Section 60 TCGA 1992 are not "transparent" for capital gains tax purposes, complex additional rules are required to deal with the consequences, and in particular the avoidance possibilities, to which an "opaque" trust gives rise. While this is not the place for a detailed analysis of those additional rules, a good example are the rules which can attribute capital gains of non-UK-resident or dual-resident settlements to certain UK-resident settlors[312] or to beneficiaries[313] of such settlements. These rules limit the scope for deferring UK capital gains tax by allowing gains to roll up untaxed in trusts which are otherwise outside the UK taxing jurisdiction.

There are also rules which can relieve from capital gains tax a disposal of an interest in a trust falling outside Section 60 TCGA[314]. These rules reflect the fact that the UK-resident trust is itself a separate taxable person for capital gains tax purposes. Therefore a further tax charge should not necessarily arise when disposing of a trust interest which reflects underlying gain which is taxable at trust level. Otherwise there would be double taxation. However, these tax-relieving rules on the disposals of trust interests are in turn disapplied in a number of cases to limit avoidance[315]. That in turn resurrects the risk of economic double taxation of trust capital gains: once at the level of the trust and again at the level of the beneficiaries.

4.3.5 Trusts with no vested interest in possession: income tax and capital gains tax

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[310] Section 71(2) TCGA.

[311] Furthermore, Chapter 4 Part 2 Finance Act 2005 creates a special elective tax regime for trusts for "vulnerable beneficiaries" (essentially certain minors who are orphaned or who are the victims of crime; plus disabled persons). This regime does not give rise to a fully "transparent" trust for income tax and capital gains tax purposes. However, it does permit the trustees' income and capital gains tax liabilities to be modified by reference to what the tax position would have been if the "vulnerable beneficiary" had been directly entitled to the trust's income and gains. Because of certain tax reliefs and exemptions which are available to individuals but not to trustees (e.g. the income tax personal allowance), this is likely to lead to a reduced effective rate on the trust's income and gains.

[312] Section 86 and Schedule 5 TCGA.

[313] Sections 87 to 96 TCGA.

[314] See Section 76 TCGA. In *Harthan v Mason* [1980] STC 94, it was made clear that what is now Section 76 TCGA could not apply to a disposal of an interest in a trust within Section 60 TCGA because such a trust is not "settled property" for capital gains tax purposes.

[315] See Section 76(1A) and (1B) TCGA, Section 76A and Schedule 4A TCGA and Section 85 TCGA. Section 85 in particular disapplies the Section 76 exemption when an interest in a non-UK-resident trust is disposed of, on the assumption that the trust may well not be subject to UK capital gains tax. However, this is not necessarily true, not least because it may be taxable in the UK on gains from disposing of certain direct or indirect holdings in UK real property.

Trusts with no vested interest in possession are by definition outside Section 60 TCGA. Therefore, they are not "transparent" for capital gains tax purposes and are subject to the taxation regime summarised in 4.3.4.

The income taxation of such trusts is more complicated but ends up in practice conferring a degree of relief from income taxation on beneficiaries, to reflect income tax borne by the trustees. Thus double taxation of income at the level of both the trustees and the beneficiary is avoided. Furthermore, the tax ultimately payable on that income can managed so that it is roughly what would have been paid if the beneficiary had been entitled to the underlying trust assets directly. However, this mechanism for taxing trust income, and avoiding it being taxed twice, is a very qualified form of "transparency", not least because beneficiaries are not currently taxable on underlying trust income as it arises to the trustees and whether or not it is distributed.

The rule in *Baker v Archer-Shee* is inapplicable. Instead Part 9 ITA comes into play. In particular, Section 479 ITA charges income tax[316] at the "dividend trust rate"[317] (on dividend income) or the "trust rate" [318] (on other income of the trust) where "accumulated or discretionary income arises to the trustees of a settlement"[319] which is not a charitable trust. This charge to tax on the trustees is not merely a representative charge. Hence it differs from the income tax charge on trustees of interest in possession trusts which is "representative" i.e. its scope is qualified by the tax status of the vested income beneficiary on whose behalf the trustee is taxed.[320]

The income tax rates on the trustees of this kind of trust are equal to the highest individual income tax rates. This discourages accumulation of income within the trust. This contrasts with the corporation tax treatment of a UK-resident company whose undistributed income is taxed at a fairly low rate (currently 19%), which is significantly less than individual income tax rates. This encourages companies not to retain income. A company and a discretionary trust are often not radically dissimilar in terms of the way they are structured and function. However, they will be subject to very different regimes for taxing their income.

Section 480 ITA defines "accumulated or discretionary income" as follows:

> "(1) Income is accumulated or discretionary income so far as –
> (a) it must be accumulated, or
> (b) it is payable at the discretion of the trustees or any other person,
> and it is not excluded by subsection (3).

[316] This charge can in principle apply to relevant trusts which are non-UK-resident in respect of their UK-source income: see *IRC v Regent Trust Co Ltd (as Trustee of the Butt 1970 Settlement)* 53 TC 54. However, this will be subject to the limits on the UK income tax charge in respect of non-UK-residents in Chapter 1 Part 14 ITA (and in particular Sections 811-2 ITA). These limits will apply provided there are no actual or contingent UK-resident beneficiaries of the trust.
[317] Currently 38.1%: see Section 9 ITA. This is currently equal to the highest rate of UK income tax on individuals in respect of dividends and other "distributions".
[318] Currently 45%: see Section 9 ITA. This is currently equal to the highest rate of UK income tax on individuals.
[319] Section 466 ITA (and in particular Section 466(4)) makes clear that property held in trust is within a "settlement" unless, in essence, the trust is of a type which could fall within Section 60 TCGA (see Section 466(3), (5) and (6) ITA).
[320] See the first part of the discussion of *Baker v Archer-Shee* at 4.3.3.1.

(2) The cases covered by subsection 1(b) include cases where the trustees have, or any other person has, any discretion over one or more of the following matters[321]-
(a) whether, or the extent to which, the income is to be accumulated,
(b) the persons to whom the income is to be paid, and
(c) how much of the income is to be paid to any person.

(3) Income is excluded for the purposes of subsection (1) so far as –
(a) before being distributed, it is the income of any person other than the trustees[322],
(b) it is income from property within subsection (4), or
(c) it is income from service charges which are paid in respect of dwellings in the United Kingdom and are held on trust.

(4) Property is within this subsection if it –
(a) is held for the purposes of a superannuation fund …….[relating to a non-UK undertaking]….but
(b) is not held as a member of a property investment LLP [a form of UK LLP primarily invested in real estate]……"

The wording in Section 480(1) regarding accumulation of income or payment of income at the discretion of a trustee, etc, indicates that "accumulated or discretionary income" for Section 480 purposes means income as defined under trust law, rather than tax law[323].

However, Section 481 ITA then extends the tax charge at the dividend trust rate or the trust rate to a list of items of taxable income[324] in Section 482 ITA. Significantly, this brings into charge to income tax at the higher trust rates certain items which would not be regarded as income for trust law purposes and hence would not be taxed in the hands of a holder of a vested interest in possession under the rule in *Baker v Archer*-Shee: see 4.3.3.2. To that extent, one of the gaps (from HMRC's perspective) in the rule in *Baker v Archer-Shee* is plugged indirectly, although the result is that these items may be taxed at a rate well in excess of the effective income tax rate of any interest in possession holder.

The Section 481 charge does not apply to unit trusts (see 4.3.6) nor to charitable trusts nor to property held in relation to superannuation funds regarding non-UK undertakings. It also does not

[321] Section 480(2) ITA provides examples of the scope of Section 480(1) in a manner consistent with the broad interpretation of the predecessor legislation in *IRC v Berrill* [1981] STC 784.
[322] This effectively carves out underlying trust income to which a beneficiary is entitled under the rule in *Baker v Archer-Shee.*
[323] See also Chapter 29.2.3.2 at page 633 in Tiley's Revenue Law (9th edition): Loutzenhiser. In *Trustees of the PL Travers Will Trust v HMRC* [2014] SFTD 265, the First-Tier Tribunal (Tax) analysed the principles determining whether trust receipts are income or capital under trust law. It then applied them to two separate categories of copyright royalty received by a trust set up by the late author of Mary Poppins. On the facts, there was a direction to accumulate some of those royalties, for the purposes of Sections 479-480 ITA. This accumulation was not altered by any need to make good the value of the underlying copyright, which was a wasting asset.
[324] These items include accrued income profits of trustees in respect of debt securities; and amounts realised by the trustees under the "offshore fund" rules or in respect of "deeply discounted securities". They also include certain distributions to trustees on a redemption or repurchase of a company's shares and amounts payable to trustees under arrangements offering a choice of an income or capital return from a company. The items mentioned in the last sentence are subject to the dividend trust rate, rather than the trust rate, of tax. Interestingly, the items listed do not include a balancing charge recapturing excess capital allowances. This would ordinarily be taxed as income, even though for trust law purposes, it would simply be part of the disposal proceeds of a capital asset and hence would not be income.

apply to "accumulated or discretionary income"[325] or what would be such income barring the exclusions in Section 480(3)(a)[326]or (c).

The income tax charge at the trust rate or dividend trust rate can be mitigated by setting against it certain expenses of the trustees[327]. Those expenses must be properly chargeable to income of the trust as a matter of general trust law, ignoring the express terms of the settlement[328]. Section 486 sets out in detail the steps for grossing up the relevant expenses and setting them off against different types of income taxable at the trust rate or the dividend trust rate. Trust income offset by expenses in this way nevertheless remains taxable in the hands of the trustees at the basic rate (currently 20%) on the basis that they are "receiving or entitled" to it[329].

Relief from economic double taxation of the same income (at both trustee and beneficiary level) stems from Chapter 7 Part 4 ITA (and especially Sections 493-4 ITA). These **only** apply where an "annual payment" is made by the trustees of a settlement in the exercise of a discretion[330], **at a time when the trustees are UK-resident**. Furthermore, that payment to the beneficiary must either constitute income of the beneficiary purely because of the fact of payment[331]; or be treated as

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325 As defined in Section 480 ITA 2007 and charged under Section 479 ITA 2007.

326 This exclusion makes clear that the Section 481 charge does not apply to income already taxable at the level of the life interest holder under *Baker v Archer-Shee.*

327 Chapter 4 Part 9 ITA.

328 See Section 484(5) ITA. Hence the scope of the relief for trustee expenses cannot be expanded by providing expressly in the settlement for a broader class of expenses to be chargeable to trust income. This is consistent with case law on the less explicit predecessor legislation: see *Carver v Duncan, Bosanquet v Allen* [1985] STC 356, which also ruled that expenses incurred for the benefit of the whole trust estate (i.e. whose object is to benefit both the income and capital beneficiaries) must be charged to trust capital. For further authority on whether trust expenses are properly chargeable to income or capital of the trust, see *In re Bennett, Jones v Bennett* [1896] 1 Ch 778 and *In re Sherry, Sherry v Sherry* [1913] 2 Ch 508. The implications of *Carver v Duncan* and *In re Bennett* were explored by the Court of Appeal in *Revenue and Customs Commissioners v Trustees of the Peter Clay Discretionary Trust* [2009] STC 469. The court accepted that if trustee and other professional fees can be properly apportioned between those attributable to dealing with the income of the trust and those attributable to dealing with trust capital (including income which the trustees have decided to accumulate), then the fees attributable purely to income can be charged to income and deducted under what is now Section 484(5) ITA.

329 See Section 484(4) ITA. The "representative" basic rate charge on trustees' income is thereby reinstated where the higher rate charges in Sections 479 and 481 ITA are inapplicable.

330 Vinelott J in *IRC v Berrill* [1981] STC 784 at 798 stated (in relation to similar wording in the predecessor legislation) that the concept of the exercise of a discretion should be construed broadly. In particular, it could cover a situation where a beneficiary's right to trust income becomes indefeasible because a power of accumulation or a power to divert income to some other beneficiary or purpose comes to an end, without the trustee exercising that power.

331 This means that the payment must amount to new income (and not an advance of trust capital, even if there is underlying trust income) in the hands of the beneficiary because of the exercise of discretion. That would not be the case if the beneficiary were already entitled to the underlying trust income under the rule in *Baker v Archer-Shee.* It is generally accepted that there would be new income if a discretion were exercised in favour of the beneficiary. There is considerable authority on whether such discretionary payments are income or capital in the hands of the beneficiaries: for example, *Trustees of the Will of H.K. Brodie v IRC* 17 TC 432; *Lindus & Hortin v IRC* 17 TC 442; *Jackson's Trustees v IRC* 25 TC 13; *Cunard's Trustees v IRC* 27 TC 122. Such payments (even if made out of trust capital) are likely to be income in the hands of the beneficiary if there is evidence of an intention to create an annuity or to ensure that the beneficiary maintains a specified level of income. However, the relevant facts are key and such payments, even if recurrent, may be treated as not being income, because they are made under a power to appoint capital: see *Stevenson v Wishart* [1986] STC 74 and [1987] STC 266. In that case, it was important that the beneficiary was the object of a separate power to appoint capital and was not just an income beneficiary, even though trust capital was being applied on a recurrent basis for an "income"

income of a settlor under the rules attributing to a settlor income of a "settlement" paid to his or her relevant minor children.

Where these rules apply, the "annual payment" made by the trust is grossed up for income tax purposes at the special trust rate of 45%. The beneficiary, in particular, is treated as having paid income tax equal to the amount of that grossing-up[332]. If that beneficiary has relevant reliefs and allowances, a refund may be obtained of the tax treated as paid at source on this "annual payment". Any such refund is usually in effect a refund of the tax paid by the trustees under Sections 479 and 481 ITA. This is because much of that tax paid by the trustees when UK-resident is allocated to a "tax pool"[333]. The running total of that "tax pool" is then matched against the amount by which "annual payments" from the trust have been grossed up. Provided that the amount of the pool equals or exceeds the amount of the gross-up, the trustees have no further obligation to account for tax which the beneficiary is treated as having paid at source in respect of the "annual payment".

However, these rules are more a form of relief from economic double taxation rather than outright "transparency". The beneficiary has no entitlement to underlying income of the trust: the "source" of its income is a separate source - the exercise of a discretion in its favour. Moreover the income from that separate source does not "mirror" the characteristics of the trust's underlying income which funds it. This is highlighted by what happens if the only income of the trustees consists of dividends. In that case, the trustees will be taxed at the "dividend trust rate" of 38.1% but any discretionary payment funded by those dividends will be grossed up and taxed at 45%. In short, that payment by the trustees is a distinct revenue item which is not treated as a dividend, despite being funded by them[334]. Because the "dividend trust rate" is less than 45%, the trustees will have to make good the shortfall between 38.1% tax on their dividend income and the 45% tax treated as paid on the discretionary payment[335]. Alternatively they will have to limit the latter payment, so that the amount of the gross-up does not exceed the amount of tax on the underlying dividend income. The beneficiary's income entitlement only comes into being when that discretion is exercised and the income becomes distributable to it, which is likely to postdate the accrual and payment of underlying trust income. This is different from a classic case of "transparency" where the beneficiary is taxable on its share of underlying trust income as it arises, and whether or not it is distributed.

The beneficiary, if non-UK-resident, may be unable to use a double taxation treaty to recover UK tax treated as paid in respect of the "annual payment". In particular, the UK has increasingly insisted, when negotiating treaties, that income arising from trusts and estates be excluded from the "Other

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purpose (in that case, care home living expenses). While such a trust distribution in the form of capital will not attract income tax, it is very likely to trigger inheritance tax: see 5.3. See also Avery Jones: Trusts op. cit. page 388 at fn 83.

332 If the trust is caught by the "settlement" rules under Section 619 ITTOIA, things work differently. In that case the recipient of the annual payment is treated as having paid income tax on that amount at the additional rate of 45%. That deemed tax payment is fully creditable against the recipient's own tax liability but is not refundable: see Section 685A ITTOIA.

333 See Sections 497 and 498 ITA. The "tax pool" cannot include any amounts of UK tax which are in fact offset by the trustees claiming a credit for non-UK tax in respect of trust income. If the beneficiary receiving the income distribution from the trust is subject to UK corporation tax (which is unlikely), Section 610 CTA 2010 ignores that distribution for corporation tax purposes but the beneficiary cannot obtain a refund of tax treated as paid at source in respect of it.

334 Contrast in this regard the US tax treatment of a so-called "complex trust": see 7.2.2 below.

335 For a numerical example, see Example 18.5 on pages 556-7 in Fairpo and Salter: "Revenue Law: Principles and Practice" 37th ed. Bloomsbury Professional.

Income" Article[336]. This preserves UK taxing rights in relation to UK-resident trustees. However, as discussed below, the non-UK-resident beneficiary may be able to claim other reliefs from UK tax.

Section 111 TIOPA gives a UK-taxable beneficiary receiving discretionary income from UK-resident trustees the right to a UK foreign tax credit for creditable non-UK tax borne by those trustees. Hence to this extent, the trust is "looked through". In order for the beneficiary to claim this credit, the trustees must certify[337] to HMRC that the discretionary payment is made at least in part from income giving rise to creditable non-UK tax and from a specified source. That income must have arisen to the trustees not earlier than six years before the end of the UK tax year[338] in which the discretionary income payment is made.

The approach of Section 111 seems consistent with *Drummond v Collins* 8 TC 525. There it was decided that discretionary payments of income to UK-resident beneficiaries by the non-UK trustees of a foreign trust had as their "source" the non-UK trust fund, even though the beneficiaries had no proprietary interest in it. Of course Section 111 is limited to cases where the trustees are UK-resident, unlike *Drummond*. However, where discretionary trustees are non-UK-resident, a UK-taxable beneficiary may be able to rely on *Drummond* to claim a credit (under Sections 8 and 9 TIOPA) for non-UK tax on underlying trust income if it can show that its discretionary entitlement has been funded from the same taxed underlying income. In that case, the "source" of the discretionary payment is the same as that of the underlying income. In practice, it may be hard to "trace" a discretionary entitlement to particular taxed items of underlying trust income.

In any case, HMRC has adopted a further concessionary practice which adds an element of "transparency" to the income tax treatment of beneficiaries in trusts where there is no vested interest in possession[339]. This concession allows beneficiaries to "look through" the trust for certain additional purposes and falls into two parts. The first applies to UK-resident trusts. Where a beneficiary of such a trust receives a discretionary payment within Sections 493-4 ITA, the beneficiary may claim tax relief if and to the extent that the discretionary payment is made from underlying trust income which would have given rise to certain reliefs if it had been received directly by the beneficiary. The reliefs in question are those applying to certain tax-exempt UK government securities targeted at non-UK-residents[340]; double tax treaty relief; and any other relief which would have been

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[336] See for example Article 22(1) of the UK-US double tax treaty of 24 July 2001: SI 2002/2848. The Exchange of Notes by the UK and the US in respect of that treaty provides: "It is understood that the purpose of the exclusion from the paragraph for income paid out of trusts or the estates of deceased persons in the course of administration is to allow a recipient of such income the relief that would have been available to him under the provisions of the [treaty] had he received the income direct instead of through the trust or estate." This is a reference to the further rules and practices which HMRC has now adopted in this area and which are discussed in the main text. See also in this regard Statement of Practice 3/86. According to one commentator, the UK has sought to exclude trust and estate income from the scope of the "Other Income" Article because otherwise no UK withholding tax at all would be payable on income from a discretionary trustee: see Avery Jones: Trusts op. cit. at 396.

[337] In practice, the trustees may not be willing to undertake this certification burden.

[338] 6th April to the following 5th April.

[339] See Extra-Statutory Concession ("ESC") B18 (and for UK estates in the course of administration, ESC A14). These Concessions are of long standing but should surely be put on a statutory footing, given the tax authorities' limited powers to grant Extra-Statutory Concessions under their statutory powers to manage the tax system: see Lord Hoffmann giving the main judgment of the House of Lords in *R (on the application of Wilkinson) v Inland Revenue Commissioners* [2006] STC 270 at 276. ESC B14 is a radical modification of the statutory rules which would otherwise apply. It goes well beyond "dealing pragmatically with minor or transitory anomalies, cases of hardship at the margins or cases in which a statutory rule is difficult to formulate or its enactment would take up a disproportionate amount of parliamentary time".

[340] So-called "FOTRA Securities": see Chapter 6 Part 6 ITTOIA; and Sections 1279 and 1280 CTA 2009.

available because the beneficiary is non-UK-resident. In short, this first part of ESC B18 is targeted at non-UK-resident beneficiaries of a UK-resident discretionary trust. ESC B18 gives relief to the extent that the discretionary payment is made from income arising to the trustees within six years before the end of the UK tax year in which that payment is made[341]. The payment is treated as made ratably out of all sources of trust income on a last-in-first-out basis. Hence ESC B18 contains “tracing” rules. The trustees must be fully UK tax-compliant. The beneficiary must claim relief within five years and ten months from the end of the tax year in which it received the discretionary payment. This time limit, plus the six-year condition mentioned above, ensures that HMRC has no open-ended obligation to give relief.

The second part of ESC B18 applies where a beneficiary (whether or not UK-resident) receives a payment from discretionary trustees which is not within Sections 493-4 ITA (because non-UK-resident trustees exercise their discretion outside the UK). Where a non-UK-resident beneficiary receives a discretionary payment from trust income which would have been chargeable to UK tax if received directly by it, that beneficiary may claim by concession a UK personal tax allowance in respect of that income. It can, however, only claim relief for UK tax in fact paid by the non-UK-resident trustees on that income (e.g. UK-source rental income) from which the discretionary payment is sourced. To the extent that the payment is sourced from interest on FOTRA Securities, the beneficiary can claim a UK tax exemption for the discretionary payment.

A UK-resident beneficiary receiving a discretionary payment from non-UK-resident trustees may claim credit for UK tax in fact paid by the trustees on income funding the discretionary payment, as if the payment were from a UK-resident trust to which Chapter 7 Part 9 ITA applied[342]. The trustees must again be fully UK tax-compliant, which will include paying UK tax on UK-source income (see fn 316). The beneficiary must claim relief within five years and ten months from the end of the tax year in which it received the discretionary payment.

4.3.6 “Unit trusts”

4.3.6.1 The concept of a “unit trust”

No discussion of how trusts are treated for UK tax purposes, and whether they are “transparent”, would be complete without considering the special UK rules applicable to “unit trusts”. These are a trust-based form of collective investment vehicle which has been very widely used in the UK, both as a vehicle for retail investors and also for more sophisticated investors and forms of investment. Since the late 1990’s, “unit trusts” have increasingly been displaced, as a retail collective investment vehicle, by UK “open-ended investment companies”. However, in other areas they have continued to

[341] In a limited number of UK double tax treaties, the first limb of ESC B18 has in effect been reflected in the “Other Income” Article: see Brabazon op. cit. at page 248. For a simplified example of how ESC B18 operates, see Naomi Wells, “Staying Offshore” Taxation (17 January 2019) 12 at 13.

[342] No credit is given for any non-repayable UK tax treated as paid on income of the non-UK-resident trustees, where that tax would not be capable of entering the “tax pool” (see above) if the trustees had been UK-resident. The most obvious example of this was the old UK “tax credit” on dividend income, which was abolished in 2016. However, this non-repayable tax is ignored when grossing up the beneficiary’s discretionary income for the purposes of ESC B18. ESC B18 should also entitle the UK-resident beneficiary to a foreign tax credit for non-UK tax imposed on distributed trust income in the state of source (but not third-state tax on the trustees): see Avery Jones: Trusts op. cit at pages 402 and 405.

flourish, notably in relation to investment in UK commercial property, which has often been undertaken from outside the UK via a Jersey property unit trust or "JPUT"[343].

The current definition for tax purposes of a "unit trust scheme" is in fact in the UK's legislation regulating financial services. Section 237(1) Financial Services and Markets Act ("**FSMA**") 2000 provides that "….'unit trust scheme' means a collective investment scheme under which the property is held on trust for the participants, except that it does not include a contractual scheme." The key concept of a "collective investment scheme" is discussed below. "Contractual schemes" are a relatively new form of regulated UK collective investment structure typically used by non-retail investors. They are intended to be fully income tax-transparent in the UK and are either constituted as contractual co-ownership schemes or (more rarely) as limited partnerships formed under the Limited Partnerships Act 1907[344]. They are of limited significance to the present discussion.

"Collective investment scheme" is mainly defined, broadly, in Section 235 FSMA:

> "(1) In this Part, 'collective investment scheme' means **any arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income.** [emphasis added]
>
> (2) The arrangements must be such that the persons who are to participate ('participants') do not have day-to-day control over the management of the property, whether or not they have the right to be consulted or to give directions.
>
> (3) The arrangements must also have either or both of the following characteristics:
> (a) the contributions of the participants and the profits or income out of which payments are to be made to them are pooled;
> (b) the property is managed as a whole by or on behalf of the operator of the scheme.

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[343]The attraction of a JPUT stems mainly from its "semi-transparent" status for UK tax purposes. In particular, it has been treated as a non-UK-resident company, and hence "opaque", for UK capital gains tax and stamp duty land tax ("**SDLT**") purposes. Hence interests in it could typically be sold by non-UK-resident investors without incurring SDLT or tax on capital gains (although this capital gains tax advantage largely ended in April 2019). However, a JPUT is typically "transparent" for income tax purposes because it is formed under a governing law (e.g. Jersey) which is consistent with English law as per *Baker v Archer-Shee.* Income tax "transparency" in particular enables JPUT investors to claim capital allowances (i.e. tax depreciation) when computing their share of the underlying net rental income from the UK property. If the JPUT is "transparent" for income tax purposes, as per *Baker v Archer-Shee,* the new Schedule 5AAA TCGA allows an irrevocable election to treat it as a "transparent" partnership (within Section 59 TCGA) for the purposes of UK tax on capital gains. If the unit holders are, say, non-UK-resident tax exempts, this election can ensure that any gain on disposing of the UK property interest held by the JPUT is not taxable, which may no longer be the case otherwise. A sale of a JPUT interest will also be treated as a sale of the underlying property so that a purchaser of the JPUT will get a "stepped-up" base cost in that property for the purposes of UK tax on chargeable gains. This would not be the case if it were held by a non-UK-resident company, which cannot make the election mentioned above. The main text further discusses the UK tax treatment of "unit trusts". The UK tax benefits of a JPUT will not be available unless it is a "collective investment scheme" (see the main text) for UK regulatory purposes, This will not be the case if there is only one unitholder and may not be the case if the manager of the trust is a company affiliated with the trust's unitholders: see fn 348.

[344] "Contractual schemes" were perceived as enabling the UK to offer a non-trust-based tax-transparent collective investment vehicle which could, for example, compete with the Luxembourg "fonds commun de placements" or "FCP".

(4) If arrangements provide for such pooling as is mentioned in subsection (3)(a) in relation to separate parts of the property, the arrangements are not to be regarded as constituting a single collective investment scheme unless the participants are entitled to exchange rights in one part for rights in another.

(5) The Treasury may by order provide that arrangements do not amount to a collective investment scheme:
(a) in specified circumstances; or
(b) if the arrangements fall within a specified category of arrangement."

This definition of a "collective investment scheme" (or "**CIS**") is broad because it underpins the UK regulation of the marketing and managing of all types of collective investment structure[345]. It is not a tax definition although it has been borrowed for tax purposes. It catches all kinds of "arrangement", which will include certain types of trust but much else besides[346]. "Arrangements" in this case need not be legally enforceable.

The CIS definition has proved both broad and, in some respects, unclear. This is problematic because there are serious criminal and other consequences if a person is not properly regulated to run a CIS. Therefore, under Section 235(5) FSMA, regulations[347] have been made which expressly carve out of that definition a number of structures which potentially fall within it. The list of carve-outs is both lengthy and eclectic[348] but its impact is limited for tax purposes, meaning that the main definition in Section 235(1)-(4) remains of primary importance. Hence any trust-based structure for collective investment is likely to be a CIS and hence a "unit trust scheme"[349].

Regulations have also been published[350] purely for tax purposes which ensure that certain structures which are potentially trust-based are not taxed as "unit trust schemes". These regulations have no

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345 See in particular Section 19 FSMA.

346 Section 235(1) FSMA makes clear that participants in a CIS need not own the underlying CIS property. This would, for example, be the case if the CIS were an open-ended investment company, rather than a trust.

347 Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001 (SI 2001/1062) ("**the 2001 Order**").

348 For example, paragraph 4 of the 2001 Order provides that "arrangements do not amount to a collective investment scheme if they are operated otherwise than by way of business". Paragraph 8 carves out certain employee share schemes. Paragraph 10 states that "arrangements do not amount to a collective investment scheme if each of the participants is a body corporate in the same group as the operator [of the arrangements]". Paragraphs 19 and 20 carve out certain pension schemes. Finally paragraph 21 provides that:
"(1) Subject to subparagraph (2), no body incorporated under the law of, or any part of, the United Kingdom relating to building societies or registered societies or registered under any such law relating to friendly societies, and no other body corporate other than an open-ended investment company, amounts to a collective investment scheme.
(2) Subparagraph (1) does not apply to any body incorporated as a limited liability partnership."

349 The Supreme Court ruled in *The Financial Conduct Authority v Asset LI Inc and others* [2016] 3 All ER 93 on the meaning of Section 235 FSMA. Their ruling confirmed its breadth and fact-sensitivity but provided some useful guidance. In particular, Lord Sumption drew a distinction between (i) cases where the investor retains entire control of the relevant property but employs the services of an investment professional to advise on exploiting that property; and (ii) cases where that investor and other investors surrender control over their property to the scheme operator so that it can either be pooled or managed in common, in return for a share of the profits generated by the collective fund. Only (ii) is a CIS but it can apply even where the investors retain legal and/or beneficial ownership of the property in question (e.g. if the property is co-owned under a trust).

350 Capital Gains Tax (Definition of Unit Trust Scheme) Regulations 1988: SI 1988/266 as amended. Income Tax (Definition of Unit Trust Scheme) Regulations 1988: SI 1988/267 as amended. Capital Gains Tax (Pension Funds

bearing on the regulatory status of these structures. The most important structure carved out of "unit trust" status by these regulations, for both income tax and capital gains tax purposes, is a unit trust scheme which is a "limited partnership scheme".

The regulations provide[351] that "A unit trust scheme is a limited partnership scheme when the scheme property is **held on trust** [emphasis added] for the general partners and the limited partners in a limited partnership." Hence this carve-out should be irrelevant in relation to those forms of limited partnership which have a legal personality enabling them to own their own assets beneficially: such structures should typically not involve any trust over scheme property, so the question of "unit trust" status for tax and regulatory purposes should not arise[352]. Scottish limited partnerships have separate legal personality enabling them to own assets beneficially. Therefore, unlike English limited partnerships (which lack such personality), they should not need to rely on the 1988 Regulations to avoid being classified as "unit trust schemes" for capital gains tax and income tax purposes[353].

4.3.6.2 Tax treatment of unit trusts

4.3.6.3.2.1 Authorised unit trusts

If a trust constitutes a unit trust scheme for tax purposes, then the next key question is whether it is an "authorised unit trust scheme". This is defined in Section 237(3) FSMA as "a unit trust scheme which is authorised for the purposes of [FSMA] by an authorisation order in force under Section 243 [FSMA]". Authorisations are in essence only granted where the UK regulatory authorities are satisfied that the unit trust is of a kind which can properly be marketed to the public and, in particular, to retail investors.

Section 617 CTA 2010 then provides:

> "(1) In respect of income arising to the trustees of an authorised unit trust, and for the purposes of the provisions relating to relief for capital expenditure, the Tax Acts have effect as if:
> (a) the trustees were a UK resident company; and
> (b) the rights of the unit holders were shares in the company.
>
> (2) References in the Corporation Tax Acts to a body corporate are to be read in accordance with subsection (1)…."

Hence the income profits of an authorised unit trust are subject to corporation tax[354]. Section 618 CTA 2010 then provides that a special rate of corporation tax applies to an authorised unit trust, which is equal to the basic rate of income tax for the corresponding tax year. This is currently 20%.[355] However, dividend income of the authorised unit trust will typically be exempt from corporation tax because of the general exemption for such income[356]. Interest income will be taxable but there is

Pooling Schemes) Regulations 1996: SI 1996/1583 as amended. Income Tax (Pension Funds Pooling Schemes) Regulations 1996: SI 1996/1585 as amended.

[351] See paragraph 4 of the Capital Gains Tax (Definition of Unit Trust Scheme) Regulations 1988 and paragraph 8 of the Income Tax (Definition of Unit Trust Scheme) Regulations 1988.

[352] Of course the relevant partnership, even if not trust-based, could still be a "collective investment scheme" for UK regulatory purposes.

[353] See 2 for a fuller discussion of a Scottish partnership.

[354] Unlike its capital gains: see fn 358.

[355] The normal "mainstream" rate of corporation tax is currently 19%.

[356] See Part 9A CTA 2009.

scope for the unit trust to be treated as paying interest distributions[357] which are deductible by it for corporation tax purposes (and taxed as interest in the hands of unit holders).

An "authorised unit trust" is also treated as a UK-resident company for capital gains tax purposes[358] and its unit holders are treated as shareholders. However, Section 100(1) TCGA then provides that the capital gains of an "authorised unit trust" are not subject to capital gains tax. This helps to ensure that an "authorised unit trust" normally incurs no UK tax at the level of the unit trust itself, provided that it does not engage in activity which amounts to trading for UK tax purposes[359]. Unit holders are taxed on the income of the trust as it arises in a number of different ways[360]. In brief, the income of the unit trust is treated in every period of account as distributed to unit holders in a form which is either interest or dividends for UK tax purposes. This ensures that there is no scope for deferring investor taxation on the income of the unit trust, even if it is reinvested by the trust.

Therefore, overall, an authorised unit trust is not "transparent" for the purposes of income tax or capital gains tax. In particular, the source of the unit holder's income and gains in such a trust is its rights as a unit holder against the trustees. The trust is not "looked through" so as to treat unit holders as entitled, as they arise, to the underlying income and assets of the trust itself. In particular, unit holders typically do not pay tax on capital gains unless and until they dispose of their units at a gain. There is no unit holder entitlement to losses of the trust[361]. Overall, unit holders avoid the compliance complications to which full transparency of the trust could give rise, not least the need to identify and trace fractional interests in the underlying assets of the trust. The composition of those assets is of course likely to change, as is the make-up of the class of unit holders[362].

However, the tax treatment of an authorised unit trust ensures that there should normally be little or no tax at the level of the unit trust itself (as opposed to its unitholders). Avoiding economic double taxation in this way underpins the efficacy of an authorised unit trust as a collective investment vehicle: interposing the trust must not create extra tax compared to direct investment by unitholders in the trust's underlying investments. The trust is treated as making periodic distributions of its income (whether or not it does so in fact) which ensures timely taxation of trust income at unitholder level. Furthermore, the tax regime for authorised unit trusts allows some income distributions of the

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[357] See Regulations 18-21 Authorised Investment Funds (Tax) Regulations 2006: SI 2006/964 as amended ("The 2006 Regulations").

[358] Section 99(1) TCGA. This makes clear, inter alia, that its capital gains are only chargeable to capital gains tax, not to corporation tax on capital gains. The authorised unit trust therefore cannot access certain reliefs (e.g. group relief) available in respect of corporation tax on capital gains.

[359] The full details of the taxation of authorised unit trusts and of their unit holders is beyond the scope of this work, as is a discussion of the concept of "trading" for UK tax purposes. The relevant tax regime for taxing the trust's income and that of its unit holders is set out in the 2006 Regulations. Those Regulations set out a very similar regime for UK "open-ended investment companies" and their shareholders.

[360] See the 2006 Regulations. Section 99B TCGA ensures that unit holders get increased capital gains tax base cost in their units where those units are accumulation units. A holder of "accumulation" units is treated as receiving a distribution in respect of those units for tax purposes but receives no matching cash payment because the corresponding income is instead reinvested by the unit trust. The holder of "accumulation" units receives an addition to base cost in those units to reflect the income which has been retained and reinvested by the trust but which is still treated as distributed to the holder for tax purposes.

[361] A similar approach (see Section 103D TCGA) has been adopted in relation to contractual co-ownership schemes. These are income tax-"transparent," but non-trust-based UK collective investment schemes regulated under Section 235A FSMA. Section 103D also applies to those "offshore funds" which are income tax-"transparent" under the rule in *Baker v Archer-Shee* e.g. Luxembourg "fonds commun de placements". Units in such schemes or funds are usually not treated as shares in a company but they are treated as separate assets from the underlying assets of the scheme or fund itself.

[362] By contrast, see the earlier discussion of Section 60 TCGA at 4.3.2.

trust to be treated, for UK tax purposes, as if they were payments of (deductible) interest[363] or of dividends. Therefore, unit holders can be treated, for UK tax purposes, as receiving different forms of income which reflect the investment base and underlying income sources of the trust, even though that unit trust is regarded as a company for tax purposes. These rules therefore create an income tax result (but not a capital gains tax result) for unitholders which has some parallels with full income tax "transparency"[364].

4.3.6.2.2 Unauthorised unit trusts

Unit trusts which are not "authorised" are known as "unauthorised unit trusts". They are not automatically regarded as UK-resident, although they can be[365]. Whether or not an unauthorised unit trust is UK-resident, Section 99 TCGA will (subject to an exception mentioned below) treat it as a company, and its unitholders as shareholders, for the purposes of UK capital gains tax (not corporation tax). Hence it will not be "transparent" for those purposes, in the same way as an "authorised" unit trust. Unit holders thereby avoid the compliance complications to which full transparency of the trust could give rise, not least the need to identify and trace fractional interests in the underlying assets of the trust[366].

The exception mentioned above is if the trust is an "offshore fund" which is treated as income tax-"transparent" under the rule in *Baker v Archer-Shee*[367]*.* This will often be the case with non-UK-resident unit trusts. That kind of trust is not treated as a company and unitholders' interests in it are not usually treated as shares. They are, however, treated for capital gains tax purposes as separate assets from the underlying assets of the trust[368].

For income tax purposes, if a non-UK-resident unauthorised unit trust is governed by the law of a non-UK jurisdiction (e.g. one of the Channel Islands) which applies the rule in *Baker v Archer-Shee* when deciding the "source" of the unitholder's income, the unitholder would typically be subject to tax-"transparent" treatment consistent with *Baker v Archer-Shee*. This may lead to UK tax on undistributed as well as distributed income of that unit trust[369]. However, it may also be easier for the unitholder to claim double taxation relief (e.g. a credit for non-UK income tax borne by the trustee).

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[363] Provided that the unit trust's investments comprise specified levels of debt instruments and related derivatives: see the 2006 Regulations, and especially Regulations 18-21.
[364] This analogy can only be taken so far. If underlying income of the authorised unit trust has suffered non-UK withholding tax, the trust itself will probably be unable to claim an effective foreign tax credit for that non-UK tax. Moreover, because the unit holder is not treated as entitled to that underlying income, it will not be eligible for a UK foreign tax credit either. There is no equivalent for authorised unit trusts of Section 111 TIOPA or ESC B18: see 4.3.5 above.
[365] Whether such a unit trust is UK-resident will depend on whether it is "centrally managed and controlled" in the UK. A discussion of this concept is beyond the scope of this thesis.
[366] For a contrast, see the earlier discussion of trusts within Section 60 TCGA at 4.3.2. If the unauthorised unit trust is non-UK-resident and is treated as a company for capital gains tax purposes under Section 99 TCGA, this may make some unit holders taxable on its undistributed gains: see Sections 3-3G TCGA.
[367] See Section 99(1A) TCGA.
[368] Section 103D TCGA. Because this kind of non-UK-resident trust is not deemed to be a company, unitholders should not be taxable under Section 3 TCGA on its undistributed chargeable gains.
[369] The unit holder will get an addition to its UK base cost for capital gains tax purposes if and to the extent that it is taxed on undistributed income of the unit trust which is reinvested by the trustees: see Section 103D(4) TCGA.

The unitholder may also be able to rely on more favourable rules for computing its income from the trust[370].

If an unauthorised unit trust is UK-resident, different taxing rules prevail. These are set out in the Unauthorised Unit Trusts (Tax) Regulations 2013 (SI 2013/2819 as amended) ("**the 2013 Regulations**")[371]. The 2013 Regulations in particular create a category of "exempt unauthorised unit trusts". Such a unit trust is one whose trustees are UK-resident in the relevant period of account; whose unit holders throughout that period are "eligible investors" and which is approved by HMRC[372] as an "exempt unauthorised unit trust". "Eligible investors" are essentially those who are exempt from capital gains tax or corporation tax on a disposal of their units (other than by reason of non-UK-residence) e.g. charities, UK-approved pension funds and entities enjoying sovereign immunity (including some "sovereign wealth" funds). Hence the "exempt unauthorised unit trust" is targeted at tax-exempt unit holders. Capital gains of an "exempt unauthorised unit trust" are not subject to UK tax[373]. Income of such a trust is treated as that of the trustees, not the unit holder and is chargeable at the basic rate (currently 20%)[374]. Likewise only the trustees can claim tax relief for capital expenditure[375]. The rules discussed at 4.3.5 in relation to taxing discretionary payments by UK-resident trustees do not apply to an "exempt unauthorised unit trust".

Unit holders of an "exempt unauthorised unit trust" are treated as receiving taxable income from that trust if an amount is shown in the trust's accounts as income available for payment to them or for investment[376]. Those deemed payments to unit holders can be relieved against the net income of the trustees[377]. Hence although the income of the unit trust is treated as that of the trustees and unit holders cannot "look through" to the underlying income source, the rules should operate to minimise any income tax liability at the level of the trustees. Instead that liability is shifted to the level of the unitholders, who are of course tax-exempts.

Any UK-resident unauthorised unit trust which is not an "exempt unauthorised unit trust" is a "non-exempt unauthorised unit trust". Such unit trusts are to be treated as UK-resident companies for tax purposes and their unit holders are to be treated as shareholders[378]. Hence unit holders cannot "look through" to the underlying income source. There is a tax charge (currently at 19%) at the level of the trust, plus a potential income tax charge at the level of the unitholders, because the trust is brought within the corporation tax regime. There is no scope for a unitholder to recover or credit the tax charge at the level of the trust as and when they are taxed on trust distributions.

4.3.7 Trusts: conclusion

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[370] See the summary of the UK tax treatment of a JPUT in 4.3.6.1 and fn 343. A JPUT is a type of non-UK-resident unauthorised unit trust.

[371] The previous rules applying to UK-resident unauthorised unit trusts (especially in relation to the taxation of income) were in Sections 504-6 ITA. They were perceived to offer avoidance opportunities and have therefore been repealed.

[372] See Regulations 4-9 of the 2013 Regulations for details of the approval process. These require in particular that revenue and capital in the unit trust's accounts be computed in accordance with the Investment Management Association's Statement of Recommended Practice for the Financial Statements of Authorised Funds published in October 2010 (or any successor statement of recommended practice).

[373] Regulation 10 of the 2013 Regulations.

[374] Regulation 12(1) of the 2013 Regulations.

[375] Regulation 13 of the 2013 Regulations.

[376] Regulations 15 and 16 of the 2013 Regulations.

[377] Regulation 18 of the 2013 Regulations.

[378] Regulation 28 of the 2013 Regulations which also provides that such a unit trust is a "body corporate" for corporation tax purposes.

There has been relatively little focus on how to define a trust for UK tax purposes, especially when dealing with non-UK asset protection vehicles (notably, foundations) which can have very similar effects but which are based on non-common law legal traditions. The debate is further complicated by the UK direct tax and inheritance tax concept of "settlement" which can encompass arrangements (including foundations) which are not a trust in an English common law sense. The limited case law manages to establish a borderline between a trust and a body corporate, although much will turn on the detail of any given situation, including the non-tax effect of the arrangements under relevant non-UK law. It is easier to draw that line where beneficiaries have vested interests allowing them to dictate how underlying assets are used… unlike the members of a company. Otherwise, the borderline can be very fine indeed. How much real difference is there between a foundation (which appears to be a separate legal entity with no members and whose discretionary beneficiaries with very few rights) and a discretionary and accumulation trust (which may or may not be a separate legal entity, which has no members and whose discretionary beneficiaries have slightly greater, but still very diffuse rights)?

The borderline between a trust and a body corporate is nevertheless very important. Under UK tax law, a body corporate is not "transparent" and its members will be subject to tax on their income and gains from the body corporate, often with no offset for any tax borne at entity level on underlying income and gains. The position in relation to trusts is much less simple, and in some cases gives rise to a "transparent" approach. In addition, trusts are often subject to UK inheritance tax but this is much rarer in relation to a body corporate[379].

It would make sense to redraw the borderline between "settlements" and other entities (notably, bodies corporate and partnerships) for UK tax purposes. This will not be easy but the current borderline is too flimsy and too formalistic, which is a gift to tax planning. It would make more sense to distinguish between arrangements whose primary purpose is the conduct of business and those whose primary purpose is the protection and distribution of assets (even if investment of assets is an ancillary activity). The "settlement" label should be reserved for the latter, and their precise legal form (trust, foundation, limited company) should be immaterial[380].

The trust concept is highly malleable. At one end of the spectrum, it covers quite simple arrangements for the concurrent co-ownership of property, often with a fairly fixed class of assets and beneficiaries. At the other end, it covers more complex arrangements under which beneficiaries have a diffuse nexus with the trust property, settlor control is extensive and the role of the trustees is potentially more wide-ranging[381]. Discretionary and/or accumulation trusts are a good example of the latter arrangements. Yet again, the "unit trust" is an example of complex co-ownership arrangements where trustees often oversee the active management of a shifting and varied asset portfolio, while the class of beneficiaries is broad and fluctuating. However, in the case of "unit trusts", the holders of beneficial interests have a clear nexus with trust property.

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379 See 5.3.

380 The suggested distinction is not new. It shares much in common with the definition of a "trust" for US Federal tax purposes, which focusses on whether the purpose of an arrangement is to vest in a third party responsibility for protecting and conserving property for beneficiaries, who cannot share in the discharge of that responsibility. Those beneficiaries are not therefore associates in a joint enterprise for the conduct of business for profit. Under the US definition, it is quite possible for a foundation to be treated as a "trust", because the definition is not formalistic. For a fuller discussion: see Ismael Hajjar, Midya Omar and Suzanne Reisman: "DIFC and ADGM Foundation Laws – a UAE/US perspective": Trust Quarterly Review, Volume 17, Issue 2 (2019) 31 at 34-5. See also the discussion in 7.2.2 below.

381 Not only must they administer the trust property but they must also make sensitive decisions about who is to benefit from it, and how.

The range of trust scenarios militates against a "one size fits all" approach to the tax "transparency" of trusts, even if instinctively, one might think that a beneficiary of a trust should be taxed as if it had a share in the underlying assets and income of the trust. Therefore, the current rules often do not regard full "transparency" as an appropriate solution, especially in relation to the income taxation of discretionary and accumulation trusts. This is even truer in relation to the capital gains taxation of all trusts bar those within Section 60 TCGA. Apart from Section 60 trusts, the UK treats trusts as separate taxable persons from their beneficiaries for the purposes of taxing capital gains[382].

Even when tax "transparency" is an appropriate solution, it means different things in different scenarios [383]. Such differences may be hard to justify, not least the oddities surrounding the rule in *Baker v Archer-Shee*. Generally, UK law on whether and when trusts are "transparent" has evolved in a fairly ad hoc way.

Treating a trust as tax "transparent" can create as many problems as it solves for those with a beneficial interest in it[384]. It may avoid taxation at the level of the trust as well as at the level of those with an interest in the trust[385]. It may also give those interest holders easier access to relief for source-based tax (notably, foreign tax) on the underlying income and gains of the trust. It may even give those interest holders access to trust losses (e.g. under Section 60 TCGA). However, it may also mean that interest holders will be currently taxed on distributed and above all undistributed income and gains of the entity, with no certainty that they will have cash resources with which to pay that tax[386]. Furthermore, having an interest in a fully "transparent" trust gives the beneficiary potential compliance headaches: it must track over time the proportionate interest to which it is treated as entitled in each underlying asset and income source of that trust. Those headaches worsen if the trust's beneficiaries, its income and assets change regularly[387].

The courts are alive to the pitfalls of tax "transparency", even where it is in principle an appropriate outcome. Hence, when applying Section 60 TCGA[388], the courts in *Booth v Ellard* and in *Jenkins v Brown*[389] steered away from a fundamentalist approach to "transparency". This could otherwise have

[382] Section 69 TCGA in fact provides that "the trustees of a settlement shall, unless the context otherwise requires, together be treated as if they were a single person (distinct from the persons who are trustees of the settlement from time to time)". This departs from the normal UK approach of seeing a trust, not as an entity distinct from the trustees, but as a relationship of the latter with the beneficiaries.

[383] For example, the "look through" principle of Section 60 TCGA is much more pronounced (the trust is effectively disregarded) than transparency under the rule in *Baker v Archer-Shee*. In the latter case, the trust is not disregarded and the rule is limited to determining the tax "source" of the income of a beneficiary with a vested income interest.

[384] UK tax law does not give a beneficiary of a trust any right to elect whether or not to be taxed personally as if the trust were "transparent". This is consistent with the general UK approach of not allowing "transparent" tax treatment to be elective.

[385] Thereby simplifying some aspects of tax compliance and avoiding any risk of taxing trust income and gains twice.

[386] Such an outcome would be especially unsatisfactory for those with a diffuse interest in the assets of a trust e.g. a discretionary beneficiary.

[387] This situation could well arise in respect of an actively marketed and managed unit trust. Treating unitholders' interests in it as a separate asset for capital gains tax purposes, under Sections 99 and 103D TCGA, removes the need for unit holders to track their fractional interests in underlying trust assets. Even though the unit trust is then "opaque", its offshore location or a relevant capital gains tax exemption at the level of the trust (e.g. if it is an "authorised unit trust": see Section 100(1) TCGA) should avoid capital gains tax at the level of the entity.

[388] Which clearly requires a transparency approach to certain trusts for capital gains tax purposes.

[389] [1980] STC 555 and [1989] STC 577.

led to unfunded tax charges[390] on pooling and unpooling assets, even though there was no change in the proportionate economic interest of each participant in the asset pool.

Of course where a non-"transparency" approach is more appropriate, in order to avoid some of the pitfalls set out above[391], other issues may arise. In particular, are there two layers of taxation on the income and gains of the trust, one at the level of the trustees and the other at the level of the beneficiaries? Furthermore, if there is underlying tax at source on the income and capital gains of the trust, what relief can be given for that tax to the beneficiaries in particular? These are questions to which there is no simple answer. As discussed, an imperfect relief from what would otherwise be double taxation of trust income has been provided by the UK to beneficiaries of UK-resident discretionary and accumulation trusts. That relief has developed into a more "transparent" approach by concession[392]. So far as the capital gains of trusts are concerned[393], the response to these questions has been much more limited and piecemeal[394]. There are real risks that the capital gains of a UK-resident trust will be double-taxed, at both trustee and beneficiary level. Beneficiaries also have very little ability to access the capital losses of UK trusts[395].

In relation to "authorised" and "exempt unauthorised" unit trusts, which are collective investment vehicles, solutions other than full "transparency" have been adopted but with a result that is often similar. These solutions ensure that there is little or no "sticking" taxation of income and gain at the level of the unit trust itself[396]. By contrast, the so-called "non-exempt unauthorised unit trust" (see 4.3.6.2.2) is simply taxed as a UK-resident company, which entails taxation at both entity and investor level.

The rules regarding unit trusts can go further than merely avoiding entity-level taxation. One example is the income tax "transparency" of a non-UK-resident unit trust, provided that its governing law follows the rule in *Baker v Archer-Shee*. This avoids tax at the level of the unit trust itself and may give beneficiaries other tax benefits e.g. a more favourable basis of income computation or effective relief for tax at source on the underlying trust income. The beneficiaries will, however, be taxable on their share of that income, whether or not distributed. The UK regime for "authorised unit trusts" also does more than simply remove entity-level taxation. It enables some income distributions of the trust to be taxed as if they were payments of interest or dividends. This enables UK-taxpaying unit holders

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[390] Based on the theory that fractional interests in the underlying pooled assets were swapped between the beneficiaries of the Section 60 trust, when they pooled and later unpooled those assets.

[391] If a discretionary beneficiary is only subject to tax on income in fact distributed to it, that at least avoids it being taxed on underlying undistributed income. This is an appropriate outcome given that beneficiary's diffuse interest in the trust.

[392] That concessionary relief can apply to both UK-resident and non-UK-resident trusts. It shows a welcome willingness to apply "tax transparency" to reach an appropriate outcome even though, under classical UK income tax theory, income tax transparency has often been seen as unavailable to discretionary beneficiaries because their income stems from a "source" (the exercise of trustee discretion) which is distinct from the "source" of the underlying trust income.

[393] Other than trusts within Section 60 TCGA 1992.

[394] At a practical level, it is probably easier to avoid double taxation of capital gains in the first place by locating the residence of the trust in a tax haven. This is common practice. In that case, one need only concern oneself with taxation of any UK-taxpaying beneficiaries or the settlor, and with (any) tax at source on the underlying capital gains of the trust. Such taxation of gains at source is relatively rare (although real estate gains are a likely exception to the rule: see the recent changes to the UK taxation of capital gains of non-UK-residents from UK real estate).

[395] For a useful summary, see Davies: Principles of Tax Law, Eighth edition. Sweet & Maxwell at pages 279-286.

[396] Avoiding two layers of taxation (one at the level of the vehicle and another at the level of those holding an interest in it) is crucial if a collective investment vehicle is to be commercially viable.

to be taxed largely as if they were entitled to the unit trust's underlying income, which can be beneficial (e.g. by accessing lower tax rates on dividends).

Whether, when and how to treat an entity/arrangement as "transparent" for tax purposes is a tax policy question which is not confined to trusts, although the range of possible trust structures is reflected in a range of approaches. Very similar questions arise in relation to the taxation of companies. Of course, in the context of companies, the "solution" adopted has been more uniform and somewhat different. A company tends to be regarded as a taxable entity in its own right[397]. The question then arises what relief, if any, to give its members for entity level taxation when they derive income (especially dividends) or gain from their holdings in the company. Space does not permit a discussion of the general UK taxation of dividend income[398]. However, any relief to company members for entity-level taxation often falls well short of what it would be if that entity were tax-"transparent".

Despite some similarities between the structure of trusts and of companies, there is no automatic reason why trusts should be subject to two levels of tax: one at entity level and another at the level of the beneficiaries. Of course, in those cases where trusts are "transparent", there is ultimately one level of tax only, at beneficiary level. However, there are many cases where that is not so. Double taxation is the result. The commercial, non-tax justification for trusts is primarily that they offer a sophisticated asset protection mechanism, which can protect wealth and reconcile over time conflicting claims on that wealth. Therefore, logic would suggest that a beneficiary of a trust should not be taxed, directly or indirectly, more heavily than if that person had invested directly in the trust assets. This could be achieved without invariably treating trusts as fully "transparent" for tax purposes.

The current UK taxation rules on income and, in particular, capital gains of trusts generally fall well short of achieving tax neutrality between direct investment and investment via a trust, especially when the trustees are UK-resident. The main beneficiary of this is the "offshore trusts" industry, in jurisdictions such as Jersey and Guernsey. At the very least, the UK should change its rules on income or capital distributions so that beneficiaries who are taxed on those distributions can effectively "trace" them to underlying income and capital gains of the trust. They could then be taxed as if they had received a slice of that income or gain, benefiting from any preferential tax rates on those items. They could also benefit from relief in respect of non-UK tax on the underlying income source and any UK tax already collected at the level of the trustees. This change of approach would build on the limited "transparency" foundations of ESC B13 in relation to income tax, and Section 87 TCGA in relation to distributions of capital gain from non-UK-resident trusts. It goes beyond the narrow rule in *Baker v Archer-Shee* by offering a measure of "transparency" without taxing beneficiaries on undistributed income or gain, and without automatically giving them a heavy compliance burden[399]. It does not of course address the issue of inheritance tax on "settlements", which is discussed in 5.3.

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[397] For philosophical reasons that are contested: "Tiley's Revenue Law" (9th ed.) Loutzenhiser at 59.4.2. Notable exceptions to this approach are the UK limited liability partnership and European Economic Interest Groupings: see 2.7.

[398] Since the inception of corporation tax in 1965, the UK has taxed dividends in a number of radically different ways. Initially, it adopted a "classical" system where dividends were separately taxed with essentially no relief to company members for entity level taxation. It then sought to give relief to members for entity level taxation through a system of "partial imputation". This was found to contravene EU law. Since then, corporate members have enjoyed a wide-ranging exemption in respect of their dividend income. By contrast, non-corporate members are now fully taxed on dividend income with limited relief for entity level taxation.

[399] For how this is achieved in the US, Australia and New Zealand, see Brabazon op. cit. at pages 58-61 and Appendix (at pages 293-345). To prevent a trust being used to defer taxation on income and gain prior to distribution, interim taxation could be imposed at trustee level if the trustees were UK-resident (with a credit or

5. Further analysis of the concept of "tax transparency" and what it means in other areas of UK tax law.

5.1 The previous discussion has focussed on the concept of "tax transparency" as it relates in particular to the taxation of income and capital gains (notably, the income and gains of trusts). This chapter discusses further aspects of the concept of "tax transparency". It considers, inter alia, what this means, if anything, in relation to inheritance tax, Value Added Tax and stamp duty land tax. However, to begin, it is useful to consider some recent attempts at international level to define "tax transparency". These help to show how this concept contains a number of different, albeit related ideas.

5.2 The BEPS definition of "tax transparency" and related issues

As part of the OECD's output in 2015 from its highly-publicised work regarding BEPS ("Base Erosion and Profit Shifting"), a lengthy document[400] entitled "Neutralising the Effects of Hybrid Mismatch Arrangements" was published. This document embodied the conclusions of those working on BEPS Action 2: tax avoidance by using hybrid transactions and hybrid bodies and exploiting mismatches between jurisdictions in characterising such transactions and bodies. Part II of that document (and in particular Chapter 14) recommended changes to Article 1 of the OECD Model Double Taxation Convention ("**the OECD Model**") regarding "transparent entities". In particular, it recommended a new Article 1(2)[401] to read as follows:

> "For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as **wholly or partly fiscally transparent** [emphasis added] under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State."

Article 1(2) of the 2017 version of the OECD Model[402] now incorporates that wording as does (with modifications which are immaterial for present purposes) Article 3(1) of the OECD Multilateral

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refund for that tax against any subsequent tax on distributions to beneficiaries). If the trustees were not UK-resident, a sliding scale of UK tax rates on beneficiaries could be used to encourage earlier distributions (cf Section 91 TCGA). In any case, the settlor may already be subject to UK tax in respect of undistributed income and gain of the trust under the various "settlement" or anti-deferral rules. HMRC launched a consultation on all aspects of the UK taxation of trusts on 7 November 2018, although any conclusions have yet to be published: see "The Taxation of Trusts: a Review" https://www.gov.uk/government/consultations/the-of-taxation-of-trusts-a-review (accessed 12 June 2020).

[400] OECD (2015), Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241138-en.

[401] For an extensive discussion of Article 1(2), and the equivalent provisions in the OECD multilateral instrument to implement BEPS measures related to tax treaties, see "Some Reflections on the Proposed Revisions to the OECD Model and Commentaries and on the Multilateral Instrument, with respect to Fiscally Transparent Entities": Nikolakakis, Austry, Avery Jones, Baker, Blessing, Danon, Goradia, Hattingh, Inoue, Luedicke, Maisto, Miyatake, van Raad, Vann and Wiman. [2017] BTR 295. This article is hereafter referred to as "**Some Reflections**". Article 1(2) is also discussed further at 6.1.

[402] http://www.oecd.org/ctp/model-tax-convention-on-income-and-on-capital-full-version-9a5b369e-en.htm (accessed 2 July 2020).

Convention to implement tax treaty-related measures to prevent Base Erosion and Profit Shifting ("**the MLI**"). The MLI[403] was first signed on 24 November 2016[404].

Article 1(2) applies to the cross-border taxation of income and gains. In particular, it is a limited attempt to ensure that a double taxation treaty does not give rise to double taxation or unintended double non-taxation of cross-border income which flows via an intermediate entity, simply because the parties to the treaty characterise that entity differently. It is accompanied by revisions to the Commentary on Article 1 of the OECD Model. In particular, paragraphs 9 and 10 of the Commentary on Article 1 now read:

> "9. The concept of 'fiscally transparent' …..refers to situations where, under the domestic law of a Contracting State, the income (or part thereof) of the entity or arrangement is not taxed at the level of the entity or the arrangement but at the level of the persons who have an interest in that entity or arrangement. This will normally be the case where the amount of tax payable on a share of the income of an entity or arrangement is determined separately in relation to the personal characteristics of the person who is entitled to that share so that the tax will depend on whether that person is taxable or not, on the other income that the person has, on the personal allowances to which the person is entitled and on the tax rate applicable to that person; also, the character and source, as well as the timing of the realisation, of the income for tax purposes will not be affected by the fact that it has been earned through the entity or arrangement. The fact that the income is computed at the level of the entity or arrangement before the share is allocated to the person will not affect that result. States wishing to clarify the definition of 'fiscally transparent' in their bilateral conventions are free to include a definition of that term based on the above explanations.
>
> 10. In the case of an entity or arrangement which is treated as partly fiscally transparent under the domestic law of one of the Contracting States, only part of the income of the entity or arrangement might be taxed at the level of the persons who have an interest in that entity or arrangement as described in [the previous paragraph] whilst the rest would remain taxable at the level of the entity or arrangement. This, for example, is how some trusts and limited liability partnerships are treated in some countries (i.e. in some countries, the part of the income derived through a trust that is distributed to beneficiaries is taxed in the hands of these beneficiaries whilst the part of that income that is accumulated is taxed in the hands of the trust or trustees; similarly, in some countries, income derived through a limited partnership is taxed in the hands of the general partner as regards that partner's share of that income but is considered to be the income of the limited partnership as regards the limited partners' share of the income[405]……)".

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[403] http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf (accessed 2 July 2020).

[404] The UK signed the MLI on 7 June 2017 and deposited with the OECD its instrument of ratification and final list of reservations and notifications (regarding the MLI's operative provisions) on 29 June 2018. The MLI entered into force in the UK on 1 October 2018, as a Schedule to the Double Taxation Relief (Base Erosion and Profit Shifting) Order 2018 SI 2018/630. It began to have effect in the UK for the purposes of UK tax treaties from 1 January 2019 (for withholding tax), from 1 April 2019 (for corporation tax) and from 6 April 2019 (for income tax and capital gains tax). However, the date on which specific UK tax treaties are modified by the MLI depends on when the relevant treaty partner deposits its own instrument of ratification, acceptance and approval.

[405] For example, this would be the position in the Netherlands in relation to a so-called "open CV": see 7.3.2.

This attempt to define "tax transparency" is fairly unambitious[406]. Its focus is simply on whether or not underlying income of the entity or arrangement is taxed at the level of those with an interest in the entity or arrangement on the same basis (and at the same time)[407], and retaining the same source and character, as if the holder of that interest had been directly entitled to the underlying income. There is no requirement that the holder of that interest must be entitled to claim any tax losses of the entity or arrangement. Equally there is no requirement that under the relevant tax law, the holder of the interest must in fact be treated as owning a share of the underlying assets of the entity or arrangement. These more radical interpretations of "tax transparency" [408] are not mentioned.

A more ambitious approach to "transparency" seems to have been adopted in the UK corporation tax legislation which partly implements the proposals in part I of BEPS Action 2 Final Report for combatting avoidance (in particular, unintended double non-taxation) via hybrid mismatches. In particular, Section 259BE TIOPA reads:

> "(1) For the purposes of this Part, an entity is 'hybrid' if it meets conditions A and B.
> (2) Condition A is the entity is regarded as being a person for tax purposes under the law of any territory.
> (3) Condition B is that:
> **(a) some or all of the entity's income or profits are treated (or would be if there were any) for the purposes of a tax charged under the law of any territory, as the income or profits of a person or persons other than the person mentioned in subsection (2), or**
> **(b) under the law of a territory other than the one mentioned in subsection (2), the entity is not regarded as a distinct and separate person to an entity or entities that are distinct and separate persons under the law of the territory mentioned in that subsection……."** [emphasis added].

For these purposes, HMRC guidance (International Tax Manual INTM550630) considers that a "person" will include a partnership.

Section 259BE(3)(b) TIOPA goes further than the OECD commentary on Article 1(2). It envisages a situation where an entity is disregarded altogether for tax purposes. However, this is not a "sine qua non" of hybrid entity status for these purposes: Section 259BE(3)(a) TIOPA operates independently and is much more in line with the approach of Article 1(2) and the related Commentary. Section 259BE(3)(a) also seems broad enough to cover a situation where the entity's hybrid status arises solely because its income is treated as the income of another person under "controlled foreign

[406] The authors of "Some Reflections" indicate that paragraph 10 of the OECD Commentary on Article 1(2) is based on regulations on "fiscal transparency" under Section 894(c) US Internal Revenue Code.
[407] The issue of the timing of the tax charge is obscured by the partial transparency example of the trust in paragraph 10 of the Commentary on Article 1(2). A contrast is drawn between income taxable at beneficiary level on **distribution** [emphasis added]; versus income accumulated at trust level. Classically, if a trust arrangement is transparent, the beneficiary must be taxable on its share of underlying trust income as it arises to the trust and whether or not it is distributed. Similar points are made in "Some Reflections". In fairness to paragraph 10 of the Commentary, a more limited reading of "transparency" could cover cases where a beneficiary (e.g. of a discretionary trust) is not taxed on undistributed trust income but any distribution to it is treated as traceable to underlying trust income and gains (as under ESC B18 in the UK – see 4.3.5).
[408] See, for example, the UK capital gains tax fiction in Section 60 TCGA whereby the beneficiaries of certain trusts are treated as co-owning the underlying trust assets. This is discussed in 4.3.2.

company" or equivalent income attribution legislation.[409] Such legislation tends to have an explicit or implicit anti-deferral purpose. Hence it is not usually seen as a classic example of "tax transparency"[410].

A number of further points can be made about the meaning of "tax transparency" in the light of the debate surrounding Article 1(2) of the OECD Model Treaty.

Firstly, "tax transparency" is not a unitary concept in UK tax law. Instead it is a catchphrase which covers a range of situations where, to varying degrees, the taxation of the holder of an interest in an entity or arrangement is meant to reflect the tax result if that holder had been directly entitled to a share of the underlying income and/or assets of that entity or arrangement. The extent of this "look through" tax treatment is to varying degrees dictated by the structure and policy objective of the relevant tax rules. Where income is being taxed, the rules need not go as far as imputing ownership of underlying assets of the entity or arrangement to the holder of an interest in it. All that is needed to achieve "look through" taxation is a rule which treats the holder's income entitlement as having the same character and source, and arising at the same time, as the underlying income of the entity or arrangement, while respecting the separate existence of that entity or arrangement. A good example of this is the rule in *Baker v Archer-Shee,* discussed at 4.3.3. This kind of rule will not suffice if "look through" tax treatment is required for transactions involving underlying assets of the entity or arrangement (e.g. capital gains tax). It equally may not suffice if the interest holder is to claim losses of the entity or arrangement. Lastly, it will not be radical enough if the aim is to tax the holder of the interest as if the entity or arrangement did not exist at all e.g. if the holder wishes to claim a "participation exemption" in respect of profits from a shareholding owned by a trust or partnership in which the holder has an interest.

Secondly, where income is being taxed, is it necessary, for an entity or arrangement to be "tax transparent", that the interest holder's income entitlement has **precisely** the same character and arises at **exactly** the same time as if the underlying income had been derived directly by that holder?[411] Similarly, if the interest holder's income entitlement is treated as having the same

[409] For this to be the case, the controlled foreign company, etc legislation would have to attribute to that person the actual underlying income of the entity. It would not be enough if the relevant legislation (e.g. the UK controlled foreign company legislation – see *Bricom Holdings Ltd v IRC* [1997] STC 1179) only taxed that person on a special type of deemed income, measured by reference to, but still distinct from the entity's actual underlying income.
[410] In the legislation which preceded the new hybrid mismatch provisions in Part 6A TIOPA (see the now repealed Part 6 TIOPA and especially the former Section 236 TIOPA), it was made clear that "hybrid entity" status could **not** arise simply because the entity's profits were caught by non-UK rules equivalent to the UK "controlled foreign company" rules. The authors of "Some Reflections" consider that Article 1(2) of the OECD Model was probably not intended to cover cases where an entity's income was attributed to its members under controlled foreign company rules or equivalent anti-deferral regimes unless the relevant regime effectively disregards the entity altogether. This is probably rare: this is not the effect of the UK controlled foreign company legislation in Part 9A TIOPA. Nor is it the effect of the UK legislation regarding "settlements" in Part 5 Chapter 5 ITTOIA and the UK legislation regarding the "transfer of assets abroad" in Part 13 Chapter 2 ITA.
[411] See further in this regard "Some Reflections", which refers in particular (in fn 104) to the observation of Lord Reed (giving judgment in *Anson v HMRC* [2015] UKSC 44 at para 114): "The words 'the same' are ordinary English words. It should however be borne in mind that a degree of pragmatism in their application may be necessary in some circumstances if the object of the [double tax treaty] is to be achieved, for example where differences between UK and foreign accounting and tax rules prevent a precise matching of the income by reference to which tax is computed in the two jurisdictions."

character and source as the underlying income of the entity or arrangement, surely there is “tax transparency” even if this entitlement does not vest automatically in the holder but requires a prior decision to allocate income (e.g. by the trustees of a discretionary trust)? That allocation decision may be taken after the underlying income arose.[412]

Thirdly, if “tax transparency” is to go as far as disregarding an entity or arrangement, so that it becomes a tax “nothing”, then this will be need to be very clearly indicated in the relevant rules and is likely to occur very rarely. For example, can a UK “group” relationship between two companies be traced via a partnership (e.g. for the purposes of corporation tax “group relief”? This important question classically arises where one company is a partner in a partnership which in turn holds shares in the second company concerned.

Arguing that tracing is possible because the partnership is ”tax transparent” simply begs the question of what transparency means in this context. Whether the partnership has legal personality (e.g. a Scottish partnership) or not (e.g. an English common law general partnership), UK corporation tax rules do not clearly permit a corporate partner to demonstrate that it has the necessary “beneficial ownership” of shares held by the partnership in the second company with which it wishes to be “grouped”. Section 1258 CTA 2009 states that “Unless otherwise indicated (whether expressly or by implication) a firm[413] is not to be regarded for corporation tax purposes as an entity separate and distinct from the partners”. However, this does not mean that there is no partnership at all for tax purposes. Otherwise the reference to a “firm” would be redundant. It simply states that for income and corporation tax purposes, the firm is the aggregation of its partners and vice-versa. This is the classic English (but not Scottish) common law conception of partnership. Section 1258 therefore puts English and Scottish partnerships on an equal footing for corporation tax purposes, which is consistent with the judicial thinking mentioned in 2.9.6. However, the corporate partner wishing to establish a group relationship with another company via the partnership does not “beneficially own” any specific partnership assets (including any shares of the other company held by the partnership). Rather it has a contingent claim, in a solvent winding-up of the partnership, to a part-share in some or all of those assets net of the firm’s liabilities[414]. This point was emphasised recently in *Bayonet Ventures LLP and another v HMRC* [2018] UKFTT 262 (TC). This case considered Section 863 ITTOIA which treats a UK LLP carrying on business “with a view to profit” as being a partnership for income tax purposes. It is the income tax counterpart of Section 1273 CTA 2009. The judge pointed out that Section 863 did not treat all the activities of the LLP as carried on directly by its members. Therefore, the LLP could not simply be ignored so as to treat a loan to it by a pension fund as being made directly to the LLP members. Section 863 merely assimilated the position of LLP members with that of partners in a common law partnership.

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[412] In this regard see the discussion at 4.3.5 of, in particular, Section 111 TIOPA and ESC B18.

[413] Defined in Section 1257 CTA 2009 as persons carrying on a trade or business in partnership.

[414] There are rules enabling one company to establish its indirect “beneficial ownership” of ordinary share capital in another company but only via one or more intermediate “bodies corporate”: see Sections 1154-7 CTA 2010. Despite being formed as a body corporate, a UK limited liability partnership is typically regarded under Section 1273(1) CTA 2009 as a partnership for corporation tax purposes. Section 1273(2)(c) further specifies that for corporation tax purposes, “references to a company [which will include a body corporate] do not include such a limited liability partnership”. Section 1121(1) CTA 2010 (see 2.2) defines “company” to include a “body corporate” or an “unincorporated association” but not, inter alia, a partnership. Hence a UK limited liability partnership carrying on a business “with a view to profit” cannot normally be a “body corporate” for the purposes of Sections 1154-7 CTA 2010. It will also lack “ordinary share capital” which will prevent it being a subsidiary of another “body corporate” for those purposes.

The judge continued:

> "Property which belongs to a partnership, whether a limited liability partnership or a non-LLP, is no more the property of the individual partners than the property of a body corporate is the property of its shareholders. Such property might become the property of the members and/or shareholders upon winding up or dissolution once debts and liabilities have been paid, but until that time it is the property of the partnership (firm) or, as appropriate, the LLP, each of which are recognised in law as having a legal persona separate and distinct from the members of the partnership."

One can take issue with parts of this statement. In particular, an English partnership does not have a separate legal persona and the status of partnership property is not the same as the property of a body corporate. However, the judge was correct that individual partners cannot contend, prior to partnership dissolution, that they own particular assets forming part of the partnership property[415]. Indeed even in a solvent dissolution, all they may end up owning is cash after assets have been

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[415] The judge's thinking is supported by the Privy Council decision in *Hadlee v Commissioner of Inland Revenue* [1993] STC 294 at 297-8: Lord Jauncey, giving the sole judgment, stressed that a partner "does not have title to specific partnership property but has a beneficial interest in the entirety of the partnership assets…..This beneficial interest….is in the nature of a future interest taking effect in possession on….the determination of the partnership. ….He has rights….to share in **the surplus assets** [emphasis added] of the partnership on a dissolution". *Hadlee* was a decision regarding New Zealand law which in this respect was treated as being the same as English law. It was followed by the High Court in the VAT case of *Fengate Developments v Customs and Excise Commissioners* [2004] STC 772. In *Sandhu v Gill* [2006] 2 All ER 22 at 27-29, Neuberger LJ (as then was) made statements to the same effect as *Hadlee* in a non-tax case. Significantly, all these cases involved partnerships which did **not** have separate legal personality, which would clearly make it even harder to "look through" a partnership. An outlier is the Court of Appeal decision in *IRC v Gray* [1994] STC 360. This was a valuation case, for Capital Transfer Tax (now inheritance tax) purposes, where one of the assets was the deceased's majority share in an English law farming partnership. Was this partnership share to any extent "land"? Hoffmann LJ (as he then was) gave the sole reasoned judgment. He stated (clearly *obiter)* at page 377 that it was "land". In particular, he said "As between themselves, partners are not entitled individually to exercise proprietary rights over any of the partnership assets. This is because they have subjected their proprietary interests to the terms of the partnership deed which provides that the assets shall be employed in the partnership business, and on dissolution realised for the purposes of paying debts and distributing any surplus. **As regards the outside world, however, the partnership deed is irrelevant**. [Emphasis added] The partners are collectively entitled to each and every asset of the partnership, in which each of them has an undivided share. It is this outside view which identifies the nature of the property falling to be valued for the purpose of capital transfer tax…." With respect, these comments are not a basis for treating a partnership as a simple co-ownership arrangement when deciding whether companies can trace share ownership through a partnership in order to form a group. Hoffmann LJ's dicta clearly cannot apply where a partnership has separate legal personality. They also overstate the case in relation to an English law general partnership, where, in the "outside world", a personal creditor of a partner (but not of the firm) cannot enforce a claim against partnership property, even though the partner has an interest in it. Section 23 of the 1890 Act limits that creditor to enforcing its claim against the partner's share (i.e. its contingent claim to surplus), and not the underlying partnership property. If partners were mere co-owners of the partnership assets, a personal creditor could presumably enforce directly against the partner's vested share of the co-owned property. In a case involving estate duty (the predecessor of Capital Transfer Tax), Buckley J did not go as far as Hoffmann LJ, stating that "….(apart from some exceptional agreement) none of [the partners] has any exclusive interest in any asset of the partnership or, at any rate until all the liabilities of the partnership have been paid, any **definite share of interest in any one partnership asset** [emphasis added] capable of being realised and got in otherwise than in the liquidation of the partnership": see *Burdett-Coutts v IRC* [1960] 3 All ER 153 at 158.

liquidated and liabilities discharged. Hence the direct tax "transparency" of a partnership does not mean that, as a legal matter, one can "look through" it for the purposes of tracing a group relationship.

Strict legal analysis aside, the "tracing" position in practice is much more nuanced. The ability to trace corporate affiliation via a partnership is closely tied to the special capital gains tax "transparency" rules which apply to partnerships and LLPs. These issues are therefore examined together in greater detail in Appendix A.

There are other situations where the "tax transparency" of an entity does not entail its total disregard for UK tax purposes, even though the entity is not a taxable entity in its own right and may indeed lack legal personality. While a partnership is "tax transparent" for UK direct tax purposes, its existence will still be recognised when applying the "remittance" rules whereby individuals who are not UK-domiciled for tax purposes can defer UK tax on non-UK income and gains[416]. In particular, if such an individual applies non-UK income and gains by investing in a non-UK partnership which then invests in an asset situated in the UK, HMRC appear to accept that the non-UK partnership acts as a buffer, even though such arrangements can be very artificial. The result is that the income and gains are not a taxable "remittance" to the UK whereas there would have been a UK tax liability, on a current ("arising") basis, if the individual had used the income and gains to buy directly the underlying UK asset. The converse is also true. Hence investment in a UK partnership is the acquisition of a UK asset both for the purposes of the "remittance" rules and for inheritance tax. This is the case whether or not the partnership's assets are themselves situated in the UK[417].

Before looking at the way in which UK taxes, other than taxes on income and gain, deal with "transparency" issues, mention should be made of Appendix B. This explores specific problems when applying the "transparency" concept, for corporation tax purposes, to transactions involving certain financial and intangible assets.

5.3 Inheritance Tax and "tax transparency"

Inheritance tax ("IHT") is the UK tax on estates and gifts. It typically arises in respect of value transfers ("transfers of value") by individuals which are either gifts or which are transfers at an undervalue. It is possible that the same value transfer gives rise to CGT, which structurally is triggered by a "disposal" of "assets" (but oddly, not usually triggered by a "disposal" of a liability). However, IHT, unlike CGT, is not a tax which is targeted as "profit".

It does not matter for IHT purposes whether the transfer of value arises during the individual's lifetime or on death (e.g. under a will). However, there are very significant exemptions for certain

[416] See in particular Part 14 Chapter A1 ITA.

[417] For further comment on such situations, see Baldwin and Kiranoglu: United Kingdom Report, Volume 99b Cahiers de Droit Fiscal International, 2014 IFA Congress 835 at 839-840. From 6 April 2017, Schedule A1 Inheritance Tax Act 1984 limits the use of non-UK "close companies" and partnerships to act as a buffer shielding UK residential property from inheritance tax. However, this legislation is not a simple "look through" to the underlying UK assets. Rather,"excluded property" status, for IHT purposes, no longer applies to the interest in the company or partnership, to the extent that its value is directly or indirectly attributable to UK residential property or (broadly) loans used to acquire such property: see Emma Chamberlain "Finance (No 2) Act 2017 Notes: Section 33 and Schedule 10: inheritance tax on overseas property representing UK residential property" [2017] BTR at pages 594-605.

lifetime transfers occurring at least seven years before death[418] as well as a generous exemption for transfers between spouses, whether on or before death[419]. IHT is typically a percentage of the value of the transfer, to the extent that it is not arm's length. Rates for taxable lifetime transfers by individuals (i.e. those which for one reason or other do not get the full benefit of PET treatment) are typically half of those applying to transfers on death[420]. It is a tax imposed primarily on the transferor rather than the transferee. Overall, it is a tax on certain types of transaction, rather than on income and gain generated by such a transaction[421].

Conceptually IHT is therefore distinct from the taxation of income and gain. Nevertheless, situations arise where transfers of value or other events triggering IHT can occur which are not direct value transfers by an individual. These involve transactions carried out through interposed entities or arrangements (notably, partnerships, companies and trusts) rather than by individuals. The question is whether and how to tax those transactions by "looking through" to any individuals having an interest in, or other relevant connection with, the relevant entity or arrangement. There is no single answer to this question and there is no necessary reason why the answer in relation to IHT should be the same as that for UK tax on income or capital gains. Indeed, over the years, the IHT answer has changed, especially as it relates to IHT and trusts. The net result, since 2006 in particular, is an increasingly penal IHT regime for trusts. They are now largely taxed on an "opaque" basis, for reasons of tax policy which have been heavily criticised.

5.3.1 *Partnerships*

In relation to transfers of value involving partnerships, HMRC practice is to "look through" the partnership. To that extent, there is symmetry with the taxation of income and gains. The statutory basis for this approach is unclear but the practice seems well-established[422]. Section 267A IHTA applies specifically to UK limited liability partnerships[423]:

> "For the purposes of this Act and any other enactments relating to inheritance tax:
> (a) property to which a limited liability partnership is entitled, or which it occupies or uses, shall be treated as property to which its members are entitled, or which they occupy or use, as partners,
> (b) any business carried on by a limited liability partnership shall be treated as carried on in partnership by its members,

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418 Potentially Exempt Transfers or "PETS": Section 3A Inheritance Tax Act ("IHTA") 1984.
419 Section 18 IHTA.
420 Section 7 and Schedule I IHTA. The current maximum rate on transfers on death is 40%.
421 Certain jurisdictions tax the recipients of gifts in respect of the value received. Such taxation can be regarded as a form of income taxation. This characterisation is not readily applicable to IHT because the tax falls primarily on the transferor rather than the transferee. Furthermore, its incidence and quantum are not typically tied to the circumstances of the transferee, nor the amount received by the transferee.
422 See paragraph IHTM25094 of the HMRC Inheritance Tax Manual (accessed 17 June 2020), although, confusingly, HMRC also state in that guidance that an interest in a traditional partnership "is a 'chose in action' (the right to recover assets through an action), valued by reference to the net underlying assets of the business". HMRC practice seems to originate from the fact that an English common law partnership lacks legal personality. Of course this is not true of Scottish partnerships (as HMRC acknowledge) nor is it true of many non-UK bodies which style themselves as "partnerships".
423 These are of course, despite their name, a form of body corporate for non-tax purposes.

(c) incorporation, change in membership or dissolution of a limited liability partnership shall be treated as formation, alteration or dissolution **of a partnership**, and
(d) any transfer of value made by or to a limited liability partnership shall be treated as made by or to its members **in partnership** (and not by or to the limited liability partnership as such)".

The wording highlighted suggests that this Section does not simply disregard the LLP. Instead it assimilates the position of LLP members with that of partners in a non-LLP partnership for IHT purposes[424]. With that proviso, Section 267A "looks through" the LLP entity when subjecting its members to IHT on transactions involving the LLP assets[425]. This approach should be borne in mind when considering the IHT treatment of "close companies" (see 5.3.5 below) whose structure, operation and management may well be little different in practice from that of a UK LLP.

There is one important proviso to the general "look through" approach for IHT in relation to partnerships and UK LLPs. This relates to "business property relief"[426] which applies, inter alia, to an "interest in a business".[427] That in turn is regarded as including a share in a partnership. Hence, for these purposes, the partnership share is treated as a distinct intangible asset in its own right, and not a collection of fractional entitlements in underlying partnership assets.

5.3.2 *Trusts/settlements*

Much of the IHT legislation is given over to the taxation of trusts. A detailed analysis of those rules is beyond the scope of this thesis. The focus instead is on the varying degree to which the IHT rules "look through" certain types of trust. The broad thrust of the rules since 2006 has been not to "look

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[424] See the discussion of similar language in Section 863 ITTOIA in *Bayonet LLP and another v HMRC* [2018] UKFTT 262 (TC).
[425] HMRC Inheritance Tax Manual IHTM25094 states that "an interest in a LLP is deemed to be an interest in each and every asset of the partnership" unlike the "chose in action" approach which applies to a traditional partnership. There are quite close similarities with the IHT approach adopted for UK LLPs and that applying for capital gains tax in Section 59A TCGA. There is a lack of clarity (cf SP D12 in relation to Section 59A) about how to quantify a partner's share in LLP assets for IHT purposes. Furthermore, HMRC have been known to ignore the "look through" effect of Section 267A and to argue that, whereas "business property relief" would be available if shares in an unquoted trading company were held directly, it is not available where those shares are held by a UK LLP and a member of that LLP either dies or transfers a LLP interest. HMRC's stance (see IHTM25094) is strange although in any case "business property relief" should apply on the basis that the value of the LLP interest is attributable (at least in part) to the underlying business property (i.e. the shares): see James Kessler and Oliver Marre: " A Merry Dance" Taxation (20 March 2014) at 8.
[426] Sections 103-114 IHTA.
[427] Section 105(1)(a) IHTA. There is a similar approach in Section 227 IHTA, which deals with when IHT can be paid in instalments in relation to "qualifying property". The latter concept (see Section 227(2)) includes "a business or an interest in a business". In *Re the Nelson Dance Family Settlement, HMRC v Trustees of the Family Settlement* [2009] STC 802 at 815, Sales J (as then was) noted: "In the case where a person carries on a business, the language used in Section 105(1)(a) [for business property relief purposes] indicates that it is the business (or interest in the business) itself which is treated as the relevant business property, rather than property (such as trading stock) owned by him and used within the business". For a discussion of this case, see Marika Lemos: "*Nelson Dance*: the High Court confirms that 100% BPR may apply where the value transferred is attributable to transfers of assets used in a business". Volume VIII No 2 (April 2009) Gray's Inn Tax Chambers Review. That author agrees with the statement of Sales J cited above but regards some of his comments (obiter) (at [2009] STC 822 and 824) as exaggerating the extent to which a "business" is "property" for IHT purposes.

through" trusts. This causes disadvantages when holding property through a trust rather than directly. These disadvantages are not easy to justify.

The special IHT rules regarding trusts only apply if the arrangement involves "settled property". This means property comprised in a "settlement", as defined in Section 43 IHTA. Not all trusts are "settlements" for these purposes and, importantly, not all "settlements" are trusts. Section 43(2) to (4) reads as follows:

> "(2) Settlement means any disposition or dispositions of property, whether effected by instrument, by parol or by operation of law, or partly in one way and partly in another, whereby the property is for the time being:
>
> (a) held in trust for persons in succession or for any person subject to a contingency or
> (b) held by trustees on trust to accumulate the whole or any part of the income of the property or with power to make payments out of that income at the discretion of the trustees or some other person, with or without power to accumulate surplus income; or
> (c) charged or burdened (otherwise than for full consideration in money or money's worth paid for his own use or benefit to the person making the disposition) with the payment of any annuity or other periodical payment payable for a life or any other limited or terminable period,
>
> **or would be so held or charged or burdened if the disposition or dispositions were regulated by the law of any part of the United Kingdom; or whereby, under the law of any other country, the administration of the property is for the time being governed by provisions equivalent in effect to those which would apply if the property were so held, charged or burdened** [emphasis added].
>
> (3) A lease of property which is for life or lives, or for a period ascertainable only by reference to a death, or which is terminable on, or at a date ascertainable only by reference to, a death, shall be treated as a settlement and the property as settled property, unless the lease was granted for full consideration in money or money's worth; and where a lease not granted at a rack rent is at any time to become a lease at an increased rent it shall be treated as terminable at that time.
>
> (4) In relation to Scotland, 'settlement' also includes:
> (a) an entail;
> (b) any deed by virtue of which an annuity is charged on, or on the rents of, any property (the property being treated as the property comprised in the settlement), and
> (c) any deed creating or reserving a proper liferent of any property whether heritable or moveable (the property from time to time subject to the proper liferent being treated as the property comprised in the settlement);
>
> and for the purposes of this subsection 'deed' includes any disposition, arrangement, contract, resolution, instrument or writing."

The special rules for Scotland in Section 43(4) reflect the fact that Scottish law does not draw the same distinction as English law between the legal and equitable ownership of property (see 4.3.3.2). In particular, given its roots in French law, Scottish law can give rise to non-trust-based arrangements for enjoying another's property for life which do not exist under English law, such as the (rare) "proper liferent". This appears to be [428] the Scottish equivalent of the civil law "usufruct": namely, "the right to enjoy property belonging to another, as if its owner, at the expense of preserving that property"[429]. Importantly, Section 43(4) is confined to Scottish "proper liferents" and does not extend to usufructs in general. Furthermore, Section 43(4)(c) only makes a "proper liferent" settled property for IHT purposes, but not for other tax purposes (e.g. capital gains tax)

Section 43(3) and above all the last few lines of Section 43(2) clarify that certain entities or property-holding arrangements which would not necessarily be trusts under English law can nevertheless be "settlements" for IHT purposes. This is especially important in relation to certain non-UK arrangements for holding property, such as Anstalten or Stiftungen formed under civil law. These are widely used for the purposes of wealth preservation and, as discussed in 4.1.1, may well be characterised by English law as companies. They could nevertheless be "settlements" for IHT because of the closing words of Section 43(2)[430]. A further complication is that they may also be "close companies" for the purposes of the rules discussed at 5.3.5[431].

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[428] There is considerable debate about whether a civil law "usufruct" can in any case be treated as "settled property" under the closing words of Section 43(2) IHTA. HMRC seem to consider that a usufruct created under a civil law system other than Scotland is a "settlement" for IHT purposes because of the closing words of Section 43(2). This view is challenged in James Kessler QC op. cit. at section 98.15. If such a usufruct is not a "settlement", but a Scottish proper liferent is because of Section 43(4), the holder of the usufruct may be disadvantaged for UK tax purposes in a manner which infringes EU law. If there is a usufruct of French immovable property, another commentator has also argued that this cannot be a "settlement" within the closing words of Section 43(2) for two reasons. First, the French law of immovable property would not recognise a trust over such property in France, and English private international law would respect French law as the "lex situs". Hence the first part of the words highlighted above in Section 43(2) cannot apply. Second, because property subject to a usufruct is not centrally administered, the last part of those highlighted words is irrelevant: see the reference to "the administration of the property". For further details, see Peter Harris: "French usufruits and Section 43(2) IHTA 1984". The Tax Planning Review, Volume 7 (2018-9) at 1. In *Francoise Findlay v HMRC* [2018] UKFTT 217 (TC), the taxpayer sought a reference to the Court of Justice of the European Union on the basis that the capital gains tax treatment of the termination of a usufruct was less favourable than the termination of an English law life interest or a Scottish proper liferent, under Sections 63, 63A and 72-3. The taxpayer was seeking a stepped-up market value base cost in the relevant property when the usufruct ended, on the basis of the rules applying to life interests and proper liferents. The court ruled that a reference was premature, not least because it had yet to determine whether a usufruct was akin to a Scottish proper liferent. HMRC state, in their Capital Gains Manual at CG31301 and CG31305, that a French usufruct is "broadly similar" to a Scottish liferent. The latter is not "settled property" for capital gains tax purposes, but Section 63 TCGA treats the person entitled to possession on the death of the liferenter as acquiring the relevant assets at their then market value.

[429] This is a translation of Article 587 of the French Civil Code: see James Kessler QC op. cit. at section 98.15, page 4535. Under French law, a usufruct is not a trust but a "dismemberment" where the "usufruitier" enjoys for a prescribed period the property of another, the "nu proprietaire". Each has duties to respect the interest of the other. For a fuller discussion of the UK tax treatment of Scottish liferents in particular and of usufructs in general see sections 98.13 and 98.15 of James Kessler QC op.cit.

[430] In particular, the words "governed by provisions equivalent in effect" to a trust. It will be important to look closely at the nature of the relevant entity under its governing law: see the discussion of a Liechtenstein "stiftung" in James Kessler QC op. cit. at 98.9.5., which that commentator regards as being a "settlement" for IHT purposes. This author agrees.

[431] The IHT definition of "settlement" is not restricted to arrangements where there is an "element of bounty", unlike the "settlement" legislation in Part 5 Chapter 5 ITTOIA attributing the income of certain "settlements" to the settlor for income tax purposes. Hence some types of commercial arrangement may be caught by the IHT "settlement" provisions, although the legislation has partly mitigated this: see for example the special regime for certain employee trusts in Section 86 IHTA. It is highly unsatisfactory that technical IHT charges can arise in

However, the IHT definition of "settlement" does not catch "bare trusts" where the only beneficial interests are vested and concurrent. In other words, trusts of a kind falling within Section 60 TCGA[432] should not be IHT "settlements" and should therefore simply be "looked through" for IHT purposes[433]. HMRC consider that this will in particular be the case in relation to an absolute trust for a minor even though, under Section 31 Trustee Act 1925, the trustees have certain discretions, during the minority, to apply trust income for that beneficiary or to accumulate it. Such an arrangement does not become a "settlement" by virtue of Section 43(2)(b) IHTA because, whether income is accumulated or not, it can only ever be applied for the benefit of that beneficiary[434].

5.3.3 *Settlements with a qualifying interest in possession*

Where arrangements constitute a "settlement" for IHT purposes, a key initial question is whether there is a "qualifying interest in possession" in the settled property. If there is, then in a limited number of cases, the holder of that "interest in possession" will be treated, for IHT purposes, as beneficially owning the settled property underlying that interest, even though that is not the case as a matter of law. In particular, Section 49(1) IHTA states that:

> "A person beneficially entitled to an interest in possession in settled property shall be treated for the purposes of this Act as beneficially entitled to the property in which the interest subsists".

Whether there is an "interest in possession" requires a detailed review of the terms of the "settlement". Such an interest is not fully defined by the legislation but has been defined by the courts as a "present right to present enjoyment"[435]. This judicial statement largely reflects a press release issued by the then Inland Revenue on 12 February 1976. That press release states in particular that:

> "…an interest in possession in settled property exists where the person having the interest has the immediate entitlement (subject to any prior claim by the trustees for expenses or other outgoings properly payable out of income) to any income produced by that property as the income arises; but ….a discretion or power…which can be exercised after income arises so as to withhold it from that person negatives the existence of an interest in possession.[436]For this purpose a power to

this way in respect of commercial arrangements, although in practice HMRC appear to turn a blind eye to such issues!

[432] See 4.3.2 above.

[433] To date, it is not clear whether the judicial decisions regarding Section 60 TCGA would be applied to a "bare trust" for IHT purposes.

[434] See HMRC Inheritance Tax Manual IHTM16068 (accessed 18 June 2020).

[435] See the majority decision of the House of Lords in *Pearson v IRC* [1980] 2 All ER 479. *Pearson* has been followed by the Scottish courts: see *Miller v IRC* [1987] STC 108 and, more recently, *Trustees of the Fairbairn or Douglas Trust v HMRC* [2007] STC (SCD) 338. The latter case treated as an "interest in possession", on the facts, an "alimentary liferent", described by the judge (at page 342) as "a peculiarly Scottish device that may be used by a truster [i.e. settlor] as a means of protecting a beneficiary from his creditors (or, indeed, from himself)". Section 46 IHTA in fact defines an "interest in possession" where IHT applies to Scotland. In particular, it treats an interest under a "proper liferent" (see 5.3.2) as an "interest in possession".

[436] This was the situation in *Pearson,* according to the majority. Consequently, there was no "interest in possession". The same was true in *Re Trafford's Settlement Trusts, Moore & Osborne v IRC* [1984] STC 236, where there was a single current beneficiary of a discretionary trust of income, but the class of beneficiaries had not yet closed. Hence the single current beneficiary could not claim an immediate entitlement to the income.

accumulate income is regarded as a power to withhold it, unless any accumulations must be held solely for the person having the interest or his personal representatives. On the other hand, the existence of a mere power of revocation or appointment, the exercise of which would determine the interest wholly or in part (but which, so long as it remains unexercised, does not affect the beneficiary's immediate entitlement to income) does not …prevent the interest from being an interest in possession"[437].

A simple example of an "interest in possession" would be a vested life interest entitling the holder to any income from the settlement, although an "interest in possession" can exist even if the settlement gives rise to no income but the holder is entitled to the use or enjoyment of settled property[438]. As the 1976 press release indicates, a power on the part of trustees to accumulate income from settled property may well prevent there being an "interest in possession". However, in HMRC's view, this is not the case (at least outside Scotland) where trustee powers are merely "administrative" e.g. a power to use trust income to pay for advisers or for the upkeep and repair of trust property[439].

An "interest in possession" is "qualifying "only if it is one to which an individual is beneficially entitled[440] or it is one to which a company is beneficially entitled in certain very limited circumstances[441].

Furthermore, if an individual becomes beneficially entitled to an "interest in possession" in a settlement after 21 March 2006, it will not be a "qualifying interest in possession" unless it is an "immediate post-death interest"[442], a "disabled person's interest"[443] or a "transitional serial interest"[444]. The definitions of these categories are complex[445]. Their overall effect is, quite

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[437] The minority in the House of Lords in *Pearson* regarded the situation as falling within this last sentence. The factual distinction between the majority and minority analyses is fine.

[438] See Section 50(5) IHTA, as well as *Oakley and another (as personal representatives of Jossaume) v IRC* [2005} STC (SCD) 343, where a right to rent-free occupation of premises was an "interest in possession" and not a lease. For earlier cases where, on the facts, a right to occupy property rent-free was an "interest in possession", and not just a licence granted by the trustees, see *IRC v Lloyds Private Banking Ltd (as trustee of Irene Maude Evans, decd)* [1998] STC 559, *Woodhall (personal representative of Woodhall, deceased) v IRC* [2000] STC (SCD) 558 and *Faulkner (trustee of Adams, deceased) v IRC* [2001] STC (SCD) 112. In all these cases, it was the underlying substance that counted. For example, in *IRC v Lloyds Private Banking Ltd,* the judge said (at page 566) that the will "is dispositive and confers upon [X] a determinable life interest in the half-share [of a house] though it is dressed up as a set of administrative directions".

[439] See HMRC Inheritance Tax Manual IHTM16067 (accessed 18 June 2020). This view reflects the (fine) distinction drawn by the majority in *Pearson* between (i) "dispositive" powers under which trustees could divert the net income of the trust (e.g. by accumulating it for the benefit of other beneficiaries); and (ii) administrative powers which merely permitted trustees to deduct, from the gross income of the trust, expenses and taxes properly incurred in trust management or preserving the value of the trust assets. *Miller v IRC* [1987] STC 108 was an example of an administrative power to use income to make good depreciation of the trust assets. This did not prevent there being an "interest in possession".

[440] See Section 59(1)(a) IHTA.

[441] See Section 59(1)(b) and (2) IHTA.

[442] See Section 49A IHTA.

[443] See Section 89B IHTA.

[444] See Sections 49B-E IHTA.

[445] An "immediate post-death interest" in settled property is one to which an individual becomes beneficially entitled under a will or intestacy on the death of the testator or intestate; the settled property in question is not at any material time within Section 71A IHTA (trusts for bereaved minors); and the interest in possession is not at any material time a "disabled person's interest" (within Section 89B IHTA). A "disabled person's interest"

deliberately, to limit significantly the situations in which holding a "qualifying interest in possession" leads to the holder being treated as owning the underlying settled property[446]. In particular, it is now impossible to use a gift "inter vivos" to set up a new trust with a "qualifying interest in possession", unless it is for the benefit of a disabled person[447]. The main consequence is that much more settled property is now subject to the very different, and more onerous settled property regime discussed in 5.3.4.

The fiction that the holder of a "qualifying interest in possession" beneficially owns the underlying settled property has several IHT consequences. For example, the disposal or termination (e.g. on death) of the "qualifying interest in possession" shall be treated for IHT purposes as if the holder had made a "transfer of value" of the entire underlying settled property in which that interest subsists or subsisted[448]. The settled property is aggregated for IHT purposes with the personal property of that holder. If this transfer of value of the settled property occurs on the death of the holder of the interest in possession, then the higher IHT rates on death apply. Nevertheless no IHT is chargeable as a consequence if the holder of the interest in possession becomes beneficially entitled to the underlying settled property or to a further interest in possession in it, or, in some cases, the settled property reverts to the settlor or is transferred to the holder's spouse, widow or widower. These exceptions from IHT follow the logic of the statutory fiction that the holder of the interest in possession owns the underlying settled property. There is no IHT charge on the trust[449] itself and the IHT charge largely reflects the personal IHT profile of the interest-in-possession holder. Hence, although there is not full "transparency", the IHT regime where there is a "qualifying interest in possession" is better aligned with the IHT position where assets are owned directly, rather than via a settlement as an asset protection mechanism. Such alignment is logical if one proceeds on the basis that the settlement is a form of gift-over-time to the beneficiaries.

In some cases the statutory fiction is disapplied: if a person becomes entitled to an interest in possession because of a transaction for money or money's worth, the Section 49(1) IHTA fiction that the interest holder owns the trust property is ignored when deciding if the giving of value for that interest is itself a "transfer of value" for IHT[450]. This ensures that the actuarial value of the interest in possession is used to decide whether the person acquiring it has overpaid for it (and has thereby made a "transfer of value" to the extent of the overpayment). That actuarial value could well be less than the value of the underlying settled property e.g. if there is a life interest and that measured by reference to the life of an old person.

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requires there to be a beneficiary of the relevant settlement who is a "disabled person" (as defined). There are three different kinds of "transitional serial interest". In all three cases, the settlement must, inter alia, have commenced before 22 March 2006; it must not be a trust within Section 71A IHTA (trusts for bereaved minors); and the interest must not be a "disabled person's interest" (within Section 89B IHTA).

[446] See Loutzenhiser: Tiley's Revenue Law (9th edition) at pages 935-6 for some of the political background to these changes and, in particular, a belief by HMRC that "flexible interest in possession" trusts were being used to create tax-efficient arrangements which were little different from discretionary trusts. The latter have never been able to benefit from the less onerous "interest in possession" regime.

[447] This has important planning implications because only "inter vivos" transfers of value can benefit from the exemption for PETs

[448] See Sections 51-2 IHTA.

[449] Although the trustees can be secondarily liable for unpaid IHT.

[450] See Section 49(2) IHTA.

Because the interest in possession holder can be treated as owning the underlying settled property, any "reversionary interest" in that property is in principle "excluded property", which is ignored for IHT purposes[451]. There are, however, exceptions to that principle e.g. where the reversionary interest has at any time been acquired for money or money's worth (whether or not full value was paid). These exceptions aim to prevent avoidance based around the "excluded property" status of a "reversionary interest"[452].

5.3.4 *Settlements with no qualifying interest in possession*

If there is no "qualifying interest in possession" in a settlement, then a completely different IHT regime applies to that "settlement", and the property in that settlement is referred to as "relevant property"[453]. That regime is summarised below[454]. The summary assumes that the settlement's assets are not carved out of the "relevant property" regime as "excluded property" (e.g. because the assets are non-UK-situated and the settlor is not treated as UK-domiciled for IHT purposes).

A transfer of assets by a settlor into a "relevant property" settlement is likely to be immediately subject to IHT at lifetime rates, taking into account the settlor's "cumulative total" of chargeable transfers[455].

In addition, at each ten-year anniversary from the date when the trust was set up, there is a charge of up to 6%[456] on the then market value of the "relevant property" in the settlement[457]. The precise rate of tax depends a number of variables. These include, in particular, the then market value of the "relevant property" plus the historic value of any so-called "related settlements" created by the settlor, certain other transfers of value by the settlor, as well as the historic value of any property in the settlement which is not "relevant property" e.g. because there is a "qualifying interest in possession" in that property. Therefore, the ten-year anniversary charge is to some extent influenced by the settlor's behaviour but it takes no account of the fiscal circumstances of any beneficiary of the settlement. This is true irrespective of the nature of that beneficiary's interest.

If assets were settled after the settlement was created or after the last ten-year anniversary, then an adjustment is made to tax those assets by reference to the period for which they have been "relevant

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[451] See Section 48(1) IHTA.
[452] This concept is defined in Section 47 IHTA to include any vested or contingent "future interest" under a "settlement". In Scotland, it includes "an interest in the fee of property subject to a proper liferent".
[453] See Section 58(1) IHTA.
[454] Section 58(1) IHTA creates exceptions from the "relevant property" taxation regime for a number of specific types of settlement which would otherwise be within it e.g. charitable trusts, employee benefit trusts, certain pension schemes and "decommissioning security settlements" (created to secure legal obligations when oil fields are abandoned). Some of these exceptions relate to entirely commercial arrangements caught by the "settlement" concept. Detailed IHT rules apply to some of these specific types of settlement and, in particular, if they lose their special status e.g Section 72 IHTA.
[455] In particular, that transfer of value is usually not a PET.
[456] The maximum 6% rate is arrived at by multiplying the relevant IHT rate for transfers of value other than on death (currently 20%) by 0.3.
[457] See Sections 64 and 66 IHTA.

property"[458]. For determining this period, the relevant ten-year period[459] is split into three-month increments.

Where assets are transferred out of the settlement, there is a separate IHT "exit charge" of up to 6%[460]. A transfer out of a settlement can occur when it ends; when assets are distributed to a beneficiary or the latter otherwise becomes "absolutely entitled" to an asset (directly or under a "bare trust"); when an asset becomes part of a trust regime (e.g. a charitable trust) falling outside the main "relevant property" regime; or when there is a non-commercial transaction which reduces the value of the settled property. Different rules apply for calculating this charge depending on whether the transfer occurs before or after the first ten-year anniversary of setting up the settlement[461]. The rate of charge is also linked to the period (measured in three-month increments) that the relevant assets have been in the "relevant property" settlement since it was set up, or since the last ten-year anniversary of its creation.

Overall the tax regime applying to "relevant property" settlements does not take account of the characteristics and circumstances of beneficiaries of the settlement. It only takes limited account of the characteristics and circumstances of the settlor. Similarly it does not treat beneficiaries as entitled to a share of the underlying "relevant property", even if they have vested interests in it. Instead it treats the settlement as a separate and "opaque" taxable entity. In addition to any IHT charge on creating the original "relevant property" settlement, this regime aims to tax the "relevant property" once a generation at roughly the IHT rate for lifetime transfers of value (20%)[462]. This is very different from the IHT approach to bare trusts or to those with a "qualifying interest in possession" and is a significant deterrent to setting up trusts. It is true that the higher (40%) rate of IHT does not apply, even if major beneficiaries of the "relevant property" settlement die while it is in existence. However, this lower headline rate of IHT is more than offset by the inability to access important exemptions which can apply where a beneficiary holds property directly or via a non-"relevant property" settlement. In particular, there is no scope for the spouse exemption in Section 18 IHTA to operate in relation to a "relevant property" settlement, nor is PET treatment (under Section 3A IHTA) applicable. "Relevant property" settlements can, however, still claim business property and agricultural property relief. The settlement property may also be "excluded property" where it is non-UK-situated and the settlor is not deemed to be UK-domiciled.

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[458] This applies in particular to income of the settlement which is accumulated so that it becomes part of the "relevant property" from the date of accumulation. In some cases (see Section 64(1A)-(1C) IHTA), settlement income is treated as accumulated even if it has not been formally allocated to capital by the trustees.
[459] Up to the first ten-year anniversary or between such anniversaries.
[460] See Section 65 IHTA. This charge does not apply if in particular the appointment of assets would amount to income for tax purposes in the hands of a UK-resident. It also does not apply to payments of costs and expenses in respect of assets which are "relevant property"; nor where the relevant transfer of assets occurs within 3 months of creating the settlement or within 3 months of a 10-year anniversary: see Section 65(4) and (5) IHTA.
[461] See Sections 68-9 IHTA.
[462] See HMRC Consultation Document dated 6 June 2014: "Inheritance tax: A fairer way of calculating trust charges" at paras 2.2 and 2.29. HMRC make clear that they do not regard a settlor putting assets into a discretionary trust (where it could remain undistributed for a long period) as equivalent, for IHT purposes, to an outright gift by an individual, who has no further say in what happens to that property. While that may be true of discretionary trusts, since 2006 the "relevant property" regime also applies to many non-discretionary trusts with fully-vested beneficial interests. Such trusts are closer to outright gifts.

The 2006 changes have therefore greatly expanded the scope of an "opaque" IHT regime so that it applies to many, if not most settlements. For larger settlements in particular, this is more costly in actual tax terms, especially compared to what went before and compared to owning property directly[463]. It is also a complex and costly regime with which to comply. If the settlement is a UK-resident trust, its capital gains are also likely to be taxed on an "opaque" basis, at marginal rates of tax, as discussed in 4.3.4 and 4.3.5. It is strange that the tax rules should actively deter the use of settlements as a legitimate asset protection mechanism. Arrangements which are not "settlements" (e.g. certain company-based structures) may now offer a better method of asset protection without the burden of IHT and with no (or at least lower) tax on capital gains. This is a somewhat arbitrary outcome, not least because structurally, a private investment company with different classes of beneficial shareholding may not be that different, in legal and economic terms, from a discretionary trust.

5.3.5 *IHT: transfers of value, etc involving "close companies"*

While the IHT regime applicable to "relevant property" settlements places a clear limit on the "tax transparency" of settlements for IHT purposes, there is another situation in which IHT is imposed by "looking through" an intermediate entity to those with an interest in it. This is where that entity is a "close company".

Normally, and leaving aside "relevant property" settlements, IHT mainly applies to transfers of value by individuals[464]. However, the scope of the charge is extended by Part IV IHTA to certain transactions involving "close companies". These are defined in the same way as in CTA 2010, with the proviso that they need not be UK-resident[465].

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[463] For further discussion of these issues, see James Kessler QC: "The Quest for Fair Inheritance Taxation of Trusts" at www.kessler.co.uk/about/Two lectures by James Kessler. A particular point raised by that commentator is the almost unique nature of the UK "relevant property" regime. This makes cases of double taxation more likely, where settlements have a mix of UK and non-UK assets and/or beneficiaries. See also proposals for reform of the IHT treatment of trusts in Emma Chamberlain: "Reform of Inheritance Tax" [2020] BTR 184 and especially at 198-9, although these proposals mainly focus on ending the status quo whereby non-UK domiciliaries can set up trusts for UK-resident beneficiaries which enjoy long-term IHT-free status (because of the "excluded property" rules).

[464] See Sections 1 and 2(1) IHTA.

[465] See Section 102(1) IHTA. The definition of a "close company" in Part 10 Chapter 2 CTA 2010 is complex and broad. In very simplified form, it only applies to a company which is under the "control" of five or fewer economic "participators"; or of economic "participators" who are also "directors": see Section 439 CTA 2010. The very wide definition of "control" in Section 450 CTA 2010 is sufficient to catch many companies which are not obviously closely held. Certain publicly listed and traded companies are expressly excluded from "close company" status: see Section 446 CTA 2010. As the definition of a "close company" for IHT purposes extends to non-UK-resident companies, and as the definition of "settlement" (see 5.3.2) is not limited to trusts, there is potential for non-UK entities (e.g. stiftungen) in particular to be both "settlements" and "close companies" for IHT purposes. In part, this will depend on whether those beneficiaries can properly be regarded as "participators" in a "close company", which is doubtful given their lack of enforceable rights – see Section 454 CTA 2010. If an entity is both a "settlement" and a "close company", this may cause confusion, because the IHT rules for taxing transactions involving "close companies" operate very differently to those which apply (especially after 2006) to "settled property" (see 5.3.4). While the courts would no doubt prevent an overt double charge under both the "settled property" and "close company" rules, in relation to the same transaction, that is not the end of the story. In particular, because different IHT rules apply to "close companies" and "relevant property" settlements, IHT charges may well arise on different persons, at different times and in

Section 94 IHTA provides:

> "(1) Subject to the following provisions of [Part IV] of this Act, where a close company makes a transfer of value, tax shall be charged as if each individual to whom an amount is apportioned under this section had made a transfer of value of such amount as after deduction of tax (if any) would be equal to the amount so apportioned, less the amount (if any) by which the value of his estate is more than it would be but for the company's transfer; but for this purpose his estate shall be treated as not including any rights or interests in the company.
>
> (2) For the purposes of subsection (1) above, the value transferred by the company's transfer of value shall be apportioned among the participators[466] according to their respective rights and interests in the company[467] immediately before the transfer, and any amount so apportioned to a close company shall be further apportioned among its participators, and so on; but
> (a) so much of that value as is attributable to any payment or transfer of assets to any person which falls to be taken into account in computing that person's profits or gains or losses for the purposes of income tax or corporation tax…. shall not be apportioned and
>
> (b) if any amount which would otherwise be apportioned to an individual who is domiciled outside the United Kingdom is attributable to the value of any property outside the United Kingdom, that amount shall not be apportioned.
>
> (3) [The "surrender" of certain reliefs (e.g. losses) by one company to another for corporation tax purposes is ignored in deciding whether there is a "transfer of value" by the former company].
>
> (4) Where the amount apportioned to a person under this section is 5 per cent or less of the value transferred by the company's transfer of value, then…..tax chargeable under subsection (1) above shall be left out of account in determining, with respect to any time after the company's transfer, what previous transfers of value he has made.
>
> (5) [Provides for the limited IHT "annual exemption" in respect of lifetime transfers to apply in respect of deemed transfers of value by an individual under Section 94. This would not otherwise be the case in respect of such a deemed transfer of value, which equally cannot be a "potentially exempt transfer"]."

Hence Section 94 apportions the "transfer of value" by the "close company" to certain persons (especially individuals) with an interest in it, who are treated as having made an equivalent "transfer of value". If one of those persons with a relevant interest in the "close company" is itself a "close company", then a further apportionment can be made among those holding relevant interests in that second "close company", and so on. The scope of Section 94 has been reduced to take account of

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respect of different amounts. See also Baldwin and Kiranoglu: United Kingdom branch report Volume 99b Cahiers de Droit Fiscal International, IFA 2014 Congress 835 at 836.

[466] "Participator" is defined in the same broad manner as in Section 454 CTA 2010 but omitting anyone who would be a "participator" purely because of being a "loan creditor": see Section 102(1) IHTA. This is an important limitation on the breadth of Section 454.

[467] These are the rights and interests in the assets of the close company which could potentially be distributed to its "participators": see Section 102(2) IHTA.

ordinary corporate transactions which might otherwise trigger it. In particular, HMRC consider[468] that a dividend payment from subsidiary to parent is not a "transfer of value" for Section 94 purposes. Nor is a transfer of assets at an undervalue between a wholly-owned subsidiary and its parent; or between two wholly-owned subsidiaries. Any Section 94 charge is in fact a liability of the "close company", although there is scope to collect the tax from the "participators" if the company fails to pay[469].

Where the rights attaching to the unquoted share or loan capital of a "close company" are altered or extinguished, then Section 98 IHTA treats that transaction as an IHT "disposition" by the "participators" holding the altered or extinguished rights. That disposition can give rise to a "transfer of value".[470] Section 98(3) specifically prevents the deemed disposition from being a "potentially exempt transfer". However, because it is a deemed disposition, rather than just a deemed transfer of value, all other IHT exemptions can be invoked in respect of any transfer of value flowing from that disposition[471].

Sections 99 and 100 IHTA adapt Sections 94 and 98 IHTA in certain cases where the "participators" in the relevant "close company" include trustees of a "settlement" for IHT purposes. Section 99 provides in particular that if a transfer of value made by the company is apportioned to its trustee "participators", then if there is a "qualifying interest in possession" in the settled property, that interest shall be treated as coming to an end to the extent of that apportioned value. This may give rise to an IHT charge under Section 52 IHTA. If there is no such "interest in possession", then the trustee is treated as making a disposition reducing the value of the "settled property" by the apportioned amount.

Section 100 applies where there is an alteration in the value of a "close company"'s unquoted shares or loan capital which gives rise to a Section 98 deemed disposition and one of the affected "participators" is a "settlement" trustee. If there is a "qualifying interest in possession"[472] in that "settlement", that interest is treated[473] as ending to the extent that the alteration devalues any shares or loan capital which are both subject to the "settlement" and are attributable to that "interest in possession". Section 100 does not cover an alteration in the value of the company's shares or loan capital, when the "participator" is a trustee of a "relevant property" settlement i.e. one without a "qualifying interest in possession".

If the "close company" itself holds an "interest in possession", then that company's "participators" are generally treated as being entitled to that interest[474]. This in turn may subject them to the IHT regime for "settlements" where there is an "interest in possession". If those "participators" in turn

[468] Statement of Practice E15.
[469] Section 202 IHTA.
[470] And hence give rise to IHT. Tax on chargeable gains may also arise because of "value shifting" e.g. under Section 29 TCGA.
[471] See HMRC Inheritance Tax Manual IHTM04069 (accessed 18 June 2020).
[472] If the individual only became beneficially entitled to the interest in possession after 21 March 2006, then in most cases it must be an "immediate post-death interest", a "disabled person's interest" or a "transitional serial interest".
[473] This potentially gives rise to IHT under Section 52 IHTA.
[474] See Section 101(1) IHTA and also Statement of Practice E5. The latter is supported by *Powell-Cotton v IRC* [1992] STC 625. Generally, if the company became entitled to that interest in possession after 21 March 2006, Section 101(1) only applies if the interest is an "immediate post-death interest" or a "transitional serial interest".

include the trustees of a "settlement" in which another person holds a separate "interest in possession"[475], then the underlying "interest in possession" held by the company is further attributed via those trustees to the holder of that second "interest in possession"[476]. Consequently, a transfer of value will occur on the death of that person; or if the trustee participator's interest in the "close company" is reduced otherwise than for full consideration[477].

Part IV IHTA 1984 consists of "tax transparency" or "look through" rules which are designed to prevent avoidance of IHT which could otherwise arise if individuals could make "transfers of value" indirectly via "close companies". It partly aligns the IHT position with what it would have been had the participators owned directly the assets of the "close company". However, it stops well short of treating all transfers of value in respect of interests in a "close company" as equivalent to a pro rata transfer of that company's underlying assets. In this and other respects, Part IV resembles the capital gains tax rules regarding "close companies" in Sections 3-3G TCGA.[478] However, Part IV IHTA 1984 applies automatically if the prescribed conditions are satisfied; and whether or not the transfer of value, etc by a "close company" is connected with arrangements to avoid tax. The IHT rules regarding the taxation of "settlements" also apply automatically but are less anti-avoidance rules than a IHT response to structures for protecting and preserving wealth which do not involve direct beneficial ownership of that wealth by those standing to benefit.

As already mentioned, some entities may be both "settlements" and "close companies" for IHT purposes. In such cases, there is no clear guidance about which IHT regime should take precedence and there is a clear risk of double taxation.

5.4 Value Added Tax ("VAT") and "Tax transparency"

5.4.1 *Introduction*

VAT is a tax on the provision of goods and services[479] rather than a tax on legal persons as such. The primary relevance of legal persons is as collectors of this transaction-focussed tax. Therefore, the question rarely arises whether and how that tax should apply if the underlying transaction was regarded as carried out, not by the entity which in fact carried it out but by those with an interest in that entity.

The VAT rules therefore contain situations where entities or arrangements which are often regarded as "look through" for other tax purposes can nevertheless be treated as "opaque" for VAT purposes. This applies in particular to partnerships and trusts. Furthermore, the VAT "grouping" rules (which

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475 In the "settled property" which makes the trustees "participators".

476 Section 101(2) IHTA.

477 See HMRC Inheritance Tax Manual IHTM04092 (accessed 19 June 2020), which also makes clear that if the participators in the company are trustees of a "relevant property" settlement (i.e. with no "qualifying interest in possession"), then the participators' share of the interest in possession held by the company is treated as comprised in the "relevant property" settlement. If a person with a "qualifying interest in possession" in settled property assigns it to a "close company" which that person wholly owns, Section 101(1) IHTA treats there as being no change in the beneficial ownership of that interest.

478 Indeed the same set of facts may trigger both an apportionment for IHT purposes under Part IV IHTA and an apportionment of chargeable gains from a "close company" under Sections 3-3G TCGA.

479 Technically, it applies to "supplies" of goods and services (as defined) as well as to the "acquisition" (from within the EU) or "importation" (from outside the EU) of goods.

are a simplification measure) are a very clear, but rather specialised example of how an entity can be disregarded altogether for tax purposes. This disregard (based directly on EU law) is one which the taxpayer triggers (subject to conditions) by applying for group status. Hence VAT group status does not apply automatically to affiliates with the appropriate level of connection. This differs from group treatment for corporation tax purposes.

5.4.2 *Partnerships: General*

A partnership is not typically regarded as an entity which one "looks through" for VAT purposes. Rather, it is an entity distinct from its underlying assets and partners. In *Staatssecretaris van Financien v Heerma,*[480] the sole economic activity of a Dutch farmer was renting a cattle shed to a Dutch partnership of which he and his wife were partners. The Court of Justice of the European Union ("CJEU") regarded this as a supply for VAT purposes between two separate taxable persons, even though the purported lessor was dealing with a partnership of which he was a partner. For the purposes of what are now Articles 9 and 10 of Directive 2006/112, there was "economic activity" (because rent was being charged on an ongoing basis) and the partner was acting "independently" in relation to the partnership, not least because he was acting "in his own name, on his own behalf and under his own responsibility". The fact that the Dutch partnership lacked legal personality under Dutch law did not affect this analysis. That partnership could still be regarded as a taxable person for VAT because it still had the "de facto independence of companies", enabling it to enter into the lease[481].

The fact that one does not "look through" partnerships for VAT purposes is particularly clear when one considers the VAT treatment of (i) the admission of a new partner in return for a capital contribution; and (ii) the transfer of a partnership share. The former transaction was considered by the CJEU in *KapHag Renditefonds 35 Spreecenter Berlin-Hellersdorf 3. Tranche GbR v Finanzamt Charlottenburg*[482]. In that case, the CJEU ruled that there was no "supply" for VAT purposes by a German partnership (a Gesellschaft des buergerlichen Rechts) which invested in real estate when a new partner was admitted to the partnership in return for a capital contribution. In particular, there was no supply by the partnership to the new partner of a fractional interest in the underlying assets of the partnership[483]. The CJEU analysis did not turn on any non-tax analysis of the nature of the partnership in question e.g. whether or not it had legal personality as a matter of general law,

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480 Case C23-98 [2001] STC 1437.

481 A similar approach has been adopted more recently by the CJEU in relation to "freedom of establishment" and the UK capital gains tax exit charge on trusts: see *Trustees of the P Panayi Accumulation and Maintenance Settlements v HMRC* Case C-646/15 [2017] STC 2495. It was recognised that an English law trust is not a separate legal person and the question was therefore whether a trust was an "other legal person" which, under Article 54 of the Treaty on the Functioning of the European Union ("TFEU"), could invoke the four freedoms. The court (at pages 2517-8) adopted the thinking of Advocate-General Kokott that "that concept of 'other legal persons' extends to an entity which, under national law, possesses rights and obligations that enable it to act in its own right within the legal order concerned, notwithstanding the absence of a particular legal form, and which is profit-making". The trust met this condition because it existed to generate profits from its assets and the trust and its trustees "constitute an indivisible whole".

482 Case C-442/01 [2005] STC 1500.

483 In other words, the partnership share is seen as an asset distinct from the underlying partnership assets, even though it derives its value from them. This is akin to the distinction between a share in a company and the underlying assets of that company. See Appendix A for the entirely different approach to analysing a partnership share in Sections 59 and 59A TCGA.

although the Advocate-General's opinion seems to assume that the partnership had legal personality. HMRC Business Brief 21/2004[484] points out that VAT may arise in such cases if goods or services are contributed by the new partner to the partnership in return for being admitted. The partnership may be able to recover some or all of this VAT. However, any such tax charge[485] (on the market value of those goods and services) is effectively a clawing-back of any "input VAT" previously claimed by the new partner in respect of goods or services which are now being contributed in a transaction (admission to the partnership) which is not a "supply" by the partnership for VAT purposes. All that is acquired by the new partner is an ownership interest in the business entity, which is not analysed as a bundle of fractional interests in the underlying assets of that entity.

HMRC similarly consider, based in part on *Kretztechnik AG v Finanzamt Linz*[486], that a transfer of a partnership interest is a transfer of a chose in action which is a distinct asset from the underlying assets of the partnership[487]. Again, the VAT analysis does not "look through" to the underlying partnership assets but treats the partnership as an entity distinct from its underlying assets. Whether the transfer of that interest is a supply for VAT purposes depends on a number of factors discussed in HMRC Business Brief 30/2004[488]. However, none of these factors calls into question the distinction between the partnership interest and the underlying partnership assets. If, rarely, the disposal of the partnership interest is a "supply" (because the disponor carries on a business of dealing in such interests or it acquired the interest in order to control the partnership business) it will typically be a VAT-exempt supply of a financial service[489].

5.4.3 *Partnerships - Section 45 VATA 1994 ("VATA")*

[484] Dated 10 August 2004.

[485] Pursuant to Articles 16 and 26 of Directive 2006/112.

[486] Case C-465/03 [2005] STC 1118. In that case, the CJEU followed *KapHag.* Although *Heerma* was not cited, the Advocate-General stressed that the analysis did not turn on differences in legal characteristics between business entities (e.g. the presence or absence of legal personality). For further discussion, see Paul Williams: "VAT and Partnership Interests". Tax Journal. Issue 763, 15. 1 November 2004.

[487] Treating a partnership share as an interest in an entity distinct from the underlying partnership assets is unfamiliar in the UK direct tax context, where there is a tendency to see the partnership as an aggregation of partners' fractional interests in a pool of assets; and not as an entity in its own right. This tendency is of course influenced heavily by the nature of an English common law partnership. However, this analysis of a partnership share as a separate asset is not unique to VAT. The 2017 decision of the United States Tax Court in *Grecian Magnesite Mining, Industrial & Shipping Co, SA v Commissioner of Internal Revenue* 149 TC 3 concluded that, for US Federal income tax purposes, the redemption of an interest in a US limited liability company (taxed on a "transparent" basis as a partnership) was not a deemed disposal of a share of the underlying partnership assets, save where the tax rules clearly specified otherwise (as they only did for certain assets such as US real estate). Rather, the redemption of the partnership interest was the sale or exchange of a separate "indivisible capital asset": the taxpayer's partnership interest. The US Court of Appeals (Washington D.C. circuit) upheld the Tax Court in June 2019, but on narrower grounds relating to the US income sourcing rule known as the "US office" rule: see www.cadc.uscourts.gov decision No. 17-1268. On appeal, there was no challenge to the Tax Court's finding that the partnership interest was a single "indivisible capital asset". The *Grecian Magnesite* decision has in any case been reversed by statute for future years: see 7.2.6.2.1.

[488] Dated 19 November 2004.

[489] Because of Article 135(1)(f) Directive 2006/112 on the common system of value added tax. This has direct effect and applies in particular to "transactions…..in shares, interests in companies or associations [emphasis added]". Article 135(1)(f) is given effect in UK domestic law via Schedule 9 Group 5 VATA, but the UK transposition is much less explicit regarding dealings in partnership interests than the Directive itself.

Section 45 VATA is a special permissive rule regarding the VAT registration of partnerships. In particular, Section 45(1) provides:

> "The registration under this Act of persons:
> (a) carrying on a business in partnership, or
> (b) carrying on in partnership any other activities in the course or furtherance of which they acquire goods from other member States,
>
> **may** [emphasis added] be in the name of the firm[490]; and no account shall be taken, in determining for any purposes of this Act whether goods or services are supplied to or by such persons or are acquired by such persons from another member State, of any change in the partnership."

In Business Brief 21/2004, HMRC stress that Section 45(1) is not the legal basis for concluding that there is no supply from a partnership to an incoming partner. Nor does it have any bearing on the VAT treatment of the transfer of a partnership interest. Both these matters and their EU law analysis have been discussed at 5.4.2. Rather Section 45(1) deals, in particular, with the consequences of English common law partnerships having no legal personality and, especially, the fact that a new partner joining a partnership, or an old partner leaving it, would technically leads to a dissolution and formation of a new partnership, rather than a change to the existing one. Where it applies, Section 45 therefore treats the partners in a partnership from time to time as a separate continuing person for VAT purposes only, even if this would not otherwise be the case (e.g. under English partnership law). Hence Section 45 is a practical solution to discontinuation under English partnership law on a change of partners[491].

HMRC also consider that the Section 45 VAT registration procedure for partnerships can, and should, be used where property (e.g. land) is co-owned via a trust and is commercially exploited[492].

Where an English limited partnership is formed under the Limited Partnerships Act 1907, then current practice is that VAT registration should only be in the name(s) of the general partner(s). This is because the 1907 Act actively deters a limited partner from taking part in the management of the

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[490] HMRC guidance is to the effect that Section 45(1) allows the partnership to register in the firm name or trading style: see VAT Manual on Registration at para VATREG08800 (accessed 19 June 2020).

[491] The same discontinuation issues appear to arise under Scottish law even though Scottish partnerships are separate legal persons. There are limits on the extent to which Section 45 allows separate registrations for partnerships. In particular, if two individuals are partners in both of two distinct general partnerships, A and B, HMRC is entitled to give them a single registration under Section 45 which covers both the partnerships. There is no need to give each partnership a separate registration. This is because the effect of Section 45 is to register, in the firm name, the individual partners carrying on the business from time to time but not the partnership business as such: see *Commissioners of Customs and Excise v Glassborrow* [1974] STC 142. *Glassborrow* was distinguished in *Saunders v Sorrell* [1980] VATTR 53, where the same two individuals, X and Y, were partners in two limited partnerships. X was the general partner of one limited partnership but Y was the general partner of the other. For reasons explained in fn 493, only the general partners were regarded as carrying on business for VAT purposes. Therefore, a separate registration was required for each general partner. Had there been more than one general partner in either limited partnership, then presumably the general partners of that limited partnership could have been registered as a partnership under Section 45.

[492] See HMRC VAT Manual on Registration at VATREG09100 (accessed 19 June 2020). There is no specific provision in the VAT rules for registering trusts, so unless the trust is registered as a partnership under Section 45, it must be registered under Section 46 as a form of unincorporated association. Registration under Section 46 is discussed further at 5.4.4.

partnership business. Therefore, a limited partner cannot be treated as making VATable supplies in the course or furtherance of the partnership's business[493]. An English limited partnership is not a separate legal person and hence, if the limited partners are disregarded for registration purposes, registration can only apply to the general partner(s). By contrast, a Scottish limited partnership formed under the 1907 Act is a separate legal person, although a change in the partners may well lead to a technical dissolution. Therefore, registration of a Scottish limited partnership should be in the name of the Scottish firm.

The fact that an English limited partnership is not a separate legal person has also meant in practice that, if the general partner is a "body corporate", it has always been able to join a VAT group. If it does so, the partnership's business activities will be part of the group's activities and are dealt with under the VAT group registration: see 5.4.5 below. Treating the corporate general partner alone as a member of a VAT group seems inconsistent with the CJEU's thinking on partnerships, in the cases mentioned in 5.4.2 as well as the *Larentia and Minerva* decision (see 5.4.5).

UK LLPs are corporate bodies which are usually subject to UK direct taxation (but not VAT) as if they were partnerships. Consequently, a UK LLP should be registered as a separate corporate body for VAT purposes. A UK LLP has always been eligible to join a VAT group. Similar rules may apply, depending on the facts, to certain non-UK limited partnerships which seek a UK VAT registration and/or membership of a VAT group.

5.4.4 *Trusts*

As mentioned in 5.4.3, the VAT legislation contains no special rules for registering trusts for VAT purposes. HMRC consider that where a trust is engaged in business activity, it should be registered as a partnership under Section 45(1) VATA, with the effects described in 5.4.3. However, they also acknowledge that a trust could be VAT-registered under Section 46 VATA. This provides in particular as follows:

> "(2) The Commissioners may be regulations make provision for determining by what persons anything required by or under this Act to be done by a person carrying on a business is to be done where a business is carried on in partnership **or by a club, association or organisation** [emphasis

[493] See the decision of the VAT Tribunal in *Saunders v Sorrell* [1980] VATTR 53. HMRC appear to accept this decision, even though doubts have been cast on its correctness. The decision seems out of kilter with the CJEU's approach in the cases mentioned in 5.4.2 and in the *Larentia and Minerva* decision (see 5.4.5), which is to treat a partnership as a separate "person" for EU law purposes, even if it lacks separate legal personality under its governing law. Furthermore, the decision seems to have been based on the fact that, because the 1907 Act deters a limited partner from taking part in managing the limited partnership (on pain of losing its limited liability), there is therefore no "business" being conducted for VAT purposes by the limited partner together with the general partner. Hence there is no "business in partnership" for Section 45 purposes. Yet, if the arrangement is to be a partnership at all under the 1890 Act and the 1907 Act, there must be a "business in common" between the general partner and the limited partner(s). In any case, the definition of a "business" for VAT purposes is wide: see Section 94 VATA based on Article 9 of Council Directive 2006/112. The VAT definition of a "business" will not extend to mere passive investment (see the line of cases on what amounts to "economic activity" within Article 9, and beginning with *Polysar Investments Netherlands BV v Inspecteur der Invoerrechten en Accijnzen, Arnhem* [1993] STC 222). Those cases may occasionally be relevant if the limited partnership is an investment partnership. In *Saunders v Sorrell* itself, the limited partnerships were in fact carrying on an active business as patent agents.

added] the affairs of which are managed by its members or a committee or committees of its members.

(3) The registration under this Act of any such club, association or organisation **may** [emphasis added] be in the name of the club, association or organisation; and in determining whether goods or services are supplied to or by such a club, association or organisation or whether goods are acquired by such a club, association or organisation from another member State, no account shall be taken of any change in its members….

(6) References in this section to a 'business' include references to any other activities in the course or furtherance of which any body corporate or any club, association, organisation or other unincorporated body acquires goods from another member State."

Section 46(3) in particular is similar in effect to Section 45(1) because it ensures that a change in the make-up of the body of trustees does not affect a VAT registration of a trust under Section 46. This is especially relevant in relation to trusts under English law which do not have separate legal personality.[494] HMRC consider[495] that they cannot refuse applications for separate VAT registrations for trusts, even where each of the trusts concerned has the same trustees. Each trust is to be registered in the names of the trustees and the trust for which they act[496].

One further point to note is that a corporate trustee has in practice been allowed to join a VAT group if it meets the conditions for VAT group treatment in Section 43 VATA[497]: see 5.4.5. This may for example apply to the corporate trustee of a pension fund. If a corporate trustee of a pension fund is allowed to join a VAT group, then it will be included in that group in respect of all its business activities (both fiduciary and non-fiduciary) so long as it has been granted "unitary treatment" under Section 45 or 46 VATA by HMRC[498]. This practice regarding corporate trustees seems out of line with recent CJEU thinking (see 5.4.2) that even if a trust lacks legal personality under its governing law, the trust itself (rather than the trustee) can be a "legal person" in its own right for EU law purposes.

5.4.5 *VAT Groups*

[494] Rather than being a separate entity, a trust under English law is a series of obligations imposed on the trustee(s) and typically enforceable by the beneficiaries: see 4.1.1. However, see fn 481 regarding whether a trust lacking legal personality under its English law can nevertheless be regarded as a "legal person" for EU law purposes.
[495] See HMRC VAT Registration Manual at para VATREG12850 (accessed 19 June 2020). Contrast this approach with their stance regarding Section 45 VATA, which was upheld in *Commissioners of Customs & Excise v Glassborrow* [1974] STC 142. The difference in approach reflects the lack of legal provisions for registering trusts and trustees for VAT, compared to Section 45(1).
[496] Regulation 8 of the VAT Regulations 1995 makes all members of an entity registered under Section 46 VATA jointly and severally liable for anything required to be done by or under VATA.
[497] This is similar to the position discussed at 5.4.3 regarding the corporate general partner of an English limited partnership.
[498] See HMRC VAT Registration Manual at VATREG13000 (accessed 19 June 2020). If such "unitary treatment" is unavailable, fiduciary business activities of the corporate trustee must be accounted for outside the group registration.

The VAT grouping rules are a unique example in UK tax law of a tax grouping regime which requires one or more entities to be largely (though not entirely) disregarded and its or their activities attributed to another person. This is not the case under the "grouping" regimes which apply for the purposes of corporation tax, stamp duty and stamp duty land tax. Under those regimes, members of the group are not disregarded and their activities are not attributed to related persons. Instead, those rules simply enable group members to share certain corporation tax attributes (e.g. losses). They also generally ensure that transactions between group members are tax-neutral.

The VAT grouping rules are a form of "tax transparency" only in the sense that they largely disregard the activities of certain entities affiliated as a group and attribute them to the group's "representative member". Although subject to anti-avoidance conditions, these grouping rules are not per se anti-avoidance rules. They are a business facilitation measure for closely-related entities: eligible entities can choose whether to seek a VAT group registration. Indeed, it is possible to create more than one VAT group registration within the same corporate group[499].

The current source of the VAT grouping rules is Article 11 of Council Directive 2006/112[500] on the common system of value added tax:

> "After consulting the advisory committee on value added tax (hereafter, the 'VAT Committee'), each Member State **may regard as a single taxable person any persons** [emphasis added] established in the territory of that Member State who, while legally independent, are closely bound to one another by financial, economic and organisational links.
>
> A Member State exercising the option provided for in the first paragraph, may adopt any measures needed to prevent tax evasion or avoidance through the use of this provision."

Article 11 does not have direct effect in the domestic law of Member States: each Member State can decide whether to create a VAT grouping regime under its domestic law and how to do so, consistent with the overall effect of Article 11[501]. The UK has chosen to create a grouping regime[502].

Section 43 VATA provides in part as follows:

> "(1) Where under sections 43A to 43D any **bodies corporate** [emphasis added][503] are treated as members of a group, **any business carried on by a member of the group shall be treated as carried on by the representative member** [emphasis added], and

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[499] Conversely Section 46(1) VATA permits, in limited cases, a single "body corporate carrying on business in several divisions" to seek separate VAT registrations for the activities of those divisions.
[500] Previously Article 4(4) of the Sixth VAT Directive (77/388/EEC). There is no material difference between Article 4(4) and Article 11 of the 2006 Directive.
[501] See *HMRC v Taylor Clark Leisure Plc* [2018] UKSC 35 at para 19.
[502] See in particular, Sections 43-44 VATA.
[503] The UK historically restricted membership of a VAT group to "bodies corporate". This is a narrower concept than the corporation tax concept of "company": see Section 1121 CTA 2010. It is also narrower than the concept of "persons" mentioned in Article 11 of the 2006 Directive, which is not limited to entities with legal personality: see the decision of the CJEU in *Beteiligungsgesellschaft Larentia and Minerva mbH & Co KG v FInanzamt Nordenham* and *Finanzamt Hamburg-Mitte v Marenave Schiffahrts AG* Cases C-108/14 and C-109/14 [2015] STC 2101. Following *Larentia and Minerva*, Section 53 and Schedule 18 Finance Act 2019 introduced, from November 1 2019, relaxations of the VAT grouping rules in Section 43A VATA. The revised Section 43A is

(a) any supply of goods or services by a member of the group to another member of the group shall be disregarded; and
(b) any supply which is a supply to which paragraph (a) does not apply and is a supply of goods or services by or to a member of the group shall be treated as a supply by or to the **representative member**; and
(c) any VAT paid or payable by a member of the group on the acquisition of goods from another member State or on the importation of goods from a place outside the member States shall be treated as paid or payable by the **representative member** and the goods shall be treated:
    (i) in the case of goods acquired from another member State, for the purposes of [the duty to make returns]; and
    (ii) in the case of goods imported from a place outside the member States, for those purposes and the purposes of [the prescribed procedures on importing goods],

as acquired or, as the case may be, imported by **the representative member** [emphasis added];

and all members of the group shall be liable jointly and severally for any VAT due from the representative member.

(1AA) Where
(a) it is material, for the purposes of any provision made by or under this Act ("the relevant provision"), whether the person by or to whom a supply is made, or the person by whom goods are acquired or imported, is a person of a particular description,
(b) paragraph (b) or (c) of subsection (1) above applies to any supply, acquisition or importation, and
(c) there is a difference that would be material for the purposes of the relevant provision between:
    (i) the description applicable to the representative member, and
    (ii) the description applicable to the body which (apart from this section) would be regarded for the purposes of this Act as making the supply, acquisition or importation or, as the case may be, as being the person to whom the supply is made,

the relevant provision shall have effect in relation to that supply, acquisition or importation as if the only description applicable to the representative member were the description in fact applicable to that [other] body.

(1AB) Subsection (1AA) above does not apply to the extent that what is material for the purposes of the relevant provision is whether a person is a taxable person."

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set out in fn 505 below. In particular, a UK VAT group will be required to have at least one member which is a "body corporate" "established" or with a "fixed establishment" in the UK. However, group status will also be available in some cases where the "body/ies corporate" in question are controlled by an individual or by a partnership. It is not clear why these changes fail to cover other unincorporated entities besides partnerships e.g. trusts and unincorporated associations. This may yet fall to be tested before the courts. To some extent, the Finance Act 2019 changes have already been pre-empted in *Baillie Gifford & Co v HMRC* [2019] UKFTT 410 (TC). The judge concluded that the pre-November 1 2019 VAT grouping rules breached the EU principle of "fiscal neutrality". While Article 11 of the 2006 Directive did not have direct effect, the UK rules could still be given a conforming interpretation consistent with *Larentia and Minerva,* so that three "bodies corporate" owned directly by a Scottish partnership could form a VAT group. The same would apply if the controlling entity had been an English partnership, but not if the *controlled* entities were partnerships.

As already discussed[504], a "body corporate" for the purposes of the grouping rules can include a corporate general partner of a limited partnership and, in some cases, a limited liability partnership, as well as a corporate trustee. Under the UK rules, if a body corporate is a member of the UK VAT group, then that entire body is included in the group even if it has one or more "fixed establishments" outside the UK[505]. The effect of the grouping provisions is to largely disregard the separate existence of all the group members other than the body corporate which is chosen to be the "representative member"[506]. In effect each other member's VAT-relevant activities (its "business) are attributed to the "representative member"[507]. Supplies, etc between those other members or between any of them and the "representative member" are usually ignored for VAT purposes. Supplies, etc between non-group members and group members are treated as made by or to the "representative member"[508]. Hence, the UK implementation of Article 11 does not treat a VAT group as a notional

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[504] See 5.4.3 and 5.4.4 above.

[505] The revised Section 43A VATA now specifies when a "body corporate" and other persons are eligible to be treated as a group member. In particular:

"(1) Two or more UK bodies corporate are eligible to be treated as members of a group if
  (a) one of them controls each of the others,
  (b) one person (whether a body corporate or an individual) controls all of them, or
  (c) two or more individuals carrying on a business in partnership control all of them.

(2) ….

(3) ….

(4) An individual carrying on a business and one or more UK bodies corporate are eligible to be treated as members of a group if the individual
  (a) controls the UK body corporate or all of the UK bodies corporate, and
  (b) is established, or has a fixed establishment, in the United Kingdom in relation to the business.

(5) Two or more relevant persons carrying on a business in partnership ('the partnership') and one or more UK bodies corporate are eligible to be treated as members of a group if the partnership
  (a) controls the UK body corporate or all of the UK bodies corporate, and
  (b) is established, or has a fixed establishment, in the United Kingdom in relation to the business.

(6) In this section
  (a) 'UK body corporate' means a body corporate **which is established or has a fixed establishment in the United Kingdom** [emphasis added];
  (b) 'relevant person' means an individual, a body corporate or a Scottish partnership."

Section 43AZA determines whether a body corporate, individual or partnership "controls" a UK body corporate for Section 43A purposes.

[506] See *Commissioners of Customs & Excise v Kingfisher PLC* [1994] STC 63. Actions, rights and liabilities of an old representative member must be automatically ascribed to the new representative member on a change of representative member: see *HMRC v Taylor Clark Leisure Plc* [2018] UKSC 35 at paras 21 and 27. The representative member is therefore a continuing entity akin to a "corporation sole" whose role is fulfilled by whichever group member holds that office from time to time. It is not per se the agent or trustee of the other group members: see *HMRC v Taylor Clark Leisure Plc* [2018] UKSC 35 at para 31.

[507] An assessment for VAT due from the group is to be issued in the name of the "representative member" at the time when the assessment is **raised**, whether or not that company was a group member when the liability in fact arose: *Thorn PLC v Commissioners of Customs & Excise.* LON/96/1708.

[508] For a recent case where VAT grouping triggered recovery of input VAT on costs incurred by the general partner of an investment limited partnership, see the First-Tier Tribunal (Tax Chamber) in *Melford General Capital Partner Ltd v HMRC* [2020] UKFTT 0006(TC). The general partner was grouped with a UK LLP which provided advisory services to the limited partnership and to certain companies owned by the limited partnership via the general partner. As the group representative member, the general partner was treated as performing the services rendered by the LLP, which meant that it was treated as engaged in economic activity over and above passive share investment. Hence it was carrying on "business" for VAT purposes once grouping was taken into account and could therefore recover input VAT on its costs.

separate person embracing all its members[509], including the representative member. It simply deems most VAT-relevant activity to be carried on by the representative member only. Because Section 43 VATA does not give rise to a notional separate person embracing all group members, a repayment claim made by a group member, but not by the "representative member" itself, is not treated per se as being made by the "representative member". The situation is different if there is clear evidence that the group member makes that claim as the agent of the "representative member"[510].

The separate existence of group members other than the "representative member" is still taken into account occasionally in relation to VAT-relevant transactions[511]. In particular, Section 43(1AA) provides that one takes into account the characteristics of the group member, when taxing a supply, acquisition or importation, if the VAT-relevant characteristics of the representative member differ materially from those of the group member which would be party to the supply, etc if the grouping fiction were ignored. Section 43(1AA) is an anti-avoidance rule, permitted by Article 11.

There are also restrictions in Section 43(2A) to (2E) on the general rule disregarding intra-group supplies. These prevent some partly-exempt VAT groups (i.e. groups with restricted "input" VAT recovery) from avoiding an irrecoverable VAT cost when they buy in certain services (in particular, buying in telecoms services via the non-UK "fixed establishment" of a group member). Those services would be used to make a disregarded intra-group supply to the UK establishment of another VAT group member. Section 43(2A) to (2E) impose a "reverse charge" to VAT on the "representative member" in respect of certain supplies[512] of services between group members, even though such supplies are usually disregarded. The VAT triggered by that "reverse charge" can be recovered by the group, but only subject to the normal rules on recovering "input tax"[513]. In practice, this means that VAT recovery will be restricted.

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509 This approach to implementing Article 11 is compatible with EU law: see *Lloyds Banking Group PLC, Blackhorse Limited, MG Rover Group Limited, Standard Chartered PLC, Standard Chartered Bank, 2016 G1 Limited v HMRC and BMW (UK) Holdings Limited* [2019] EWCA Civ 485 at paras 104, 115 and 116. Contrast the different approach of the anti-fragmentation rules in paragraphs 1A and 2 Schedule 1 VATA. These are also based on Article 11. They permit HMRC in specified avoidance cases to direct that certain persons "**shall be treated as a single taxable person** [emphasis added] carrying on the activities of a business described in the direction". That fictional single taxable person is deemed to be a partnership. The Court of Appeal in *Lloyds Banking Group PLC* (see para 123 of the judgment) regarded this alternative approach as permissible too under Article 11.

510 See *HMRC v Taylor Clark Leisure Plc* [2018] UKSC 35.

511 The separate existence of each group member is, for example, recognised to the extent of making it jointly and severally liable for VAT due from the representative member.

512 There is no charge if the intra-group supplier makes the (otherwise disregarded) supply entirely out of its own resources (i.e. it does not buy in the services from outside the group); or that supply would be "exempt" anyway for UK VAT purposes under Schedule 9 VATA.

513 These rules are discussed in detail in Part 7 of VAT Notice 700/2: Group and divisional registration, which was last updated by HMRC in March 2019.

There are important differences between the UK VAT grouping rules and those adopted in other EU member states[514]. In particular, certain other jurisdictions[515] have rules which can treat a "fixed establishment" (broadly a branch) in that jurisdiction of an entity formed outside that jurisdiction as being part of a VAT group under those rules without treating the rest of that entity as belonging to that VAT group. The result of such "establishment only" grouping rules is that VATable supplies can therefore arise between a foreign entity and its "fixed establishment" in the relevant jurisdiction because, exceptionally, that establishment is treated as a separate person because it belongs to the local VAT group (which is itself a separate person for VAT). Such rules were considered by the CJEU in *Skandia America Corp (USA), filial Sverige v Skatteverket*[516]. In the wake of that case, HMRC issued Revenue and Customs Briefs 2(10 February) and 18(30 October) of 2015. These state[517] that for UK as well as non-UK VAT purposes, a non-UK "fixed establishment" of a UK-established entity can be regarded as a separate taxable person if that "fixed establishment" belongs to a VAT group in a member state (such as Sweden) with "establishment only" grouping rules. In such cases, the normal rule[518] that there can be no VATable supply between one part of a single legal entity and another will be overridden, because the relevant non-UK grouping fiction treats a branch of that entity as part of a separate person for VAT purposes. This situation can arise whether or not the UK-established entity itself belongs to a UK VAT group[519].

The *Skandia* case has caused considerable complexity and uncertainty, not least because it requires taxpayers, when applying their own domestic VAT rules, to consider the status of their "fixed establishments" under the VAT grouping rules of other EU jurisdictions[520].

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[514] Article 11 of Directive 2006/112 does not mandate the adoption of VAT grouping rules and there are apparently none in Bulgaria, Croatia, France, Greece, Lithuania, Malta, Poland, Portugal and Slovenia: see HMRC Brief 23 (11 December 2015). Italy and Luxembourg have apparently adopted VAT grouping rules recently: see Mark Agnew and Philippe Gamito: "VAT focus – VAT groups: 'reverse Skandia' for intra-entity supplies?" Tax Journal, Issue 1468 (6 December 2019) at page 24.

[515] Notably Belgium, the Czech Republic, Denmark, Estonia, Hungary, Latvia, Slovakia and Sweden: see HMRC Brief 23 (11 December 2015). Italy and Luxembourg appear to take the same position under their recently-enacted VAT grouping rules: see "VAT focus – VAT groups: 'reverse Skandia' for intra-entity supplies?" op. cit. Ireland and the Netherlands take the same approach as the UK to VAT grouping i.e. where an entity is within an Irish or Dutch VAT group, all its "fixed establishments" (wherever situated) are within that group. However, such an "establishment" could also become a separate person for VAT purposes if it is grouped with other entities under the "establishment only" grouping rules of another Member State.

[516] Case C-7/13 [2015] STC 1163. The fact pattern in that case was very similar to the situations which had previously led the UK to enact Section 43(2A) to (2E) VATA.

[517] See now in addition Part 8 of VAT Notice 700/2: Group and divisional registration, which was last updated by HMRC on 19 March 2019.

[518] See the CJEU in *Ministero dell'Economia e delle Finanze v FCE Bank* (Case C-210/04) [2007] STC 165.

[519] If the UK entity is in a UK VAT group and there is a VATable supply to that group in a *Skandia*-like situation, the Section 43(2A)-(2E) "reverse charge" rules do not also apply. This is because the non-UK "establishment only" grouping rules will treat the non-UK "fixed establishment" of the UK entity as a separate person for VAT purposes. Hence the UK VAT group can be party to a VATable transaction with that "fixed establishment" on general principles.

[520] For further discussion of these complications and a recent reference from the Swedish Supreme Court to the CJEU regarding the scope of *Skandia*, see "VAT focus – VAT groups: 'reverse Skandia' for intra-entity supplies?" op. cit. The referred case relates to a cost recharge between the head office of a Danish bank (within a Danish VAT group) and its Swedish fixed establishment which was in neither a Danish nor a Swedish VAT group. Unlike *Skandia* itself, this scenario is entirely intra-EU.

There are extensive rules to prevent the UK VAT grouping rules being used for tax avoidance purposes[521]. In particular, Sections 43B and 43C VATA permit HMRC to, respectively, refuse an application for group membership or an application to terminate group membership if refusal appears necessary "for the protection of the revenue". Such anti-avoidance legislation seems consistent with Article 11 of Directive 2006/112[522].

5.4.6 *Conclusion regarding VAT and "tax transparency"*

Overall, it seems clear that for the purposes of VAT, the concept of "tax transparency" has limited relevance. In particular, VAT is a tax on transactions and its incidence is closely linked to the nature of those transactions. Consequently, there is less need to "look through" an entity carrying out a transaction and to tax by reference to those with an interest in it, rather than by reference to the entity itself. Hence the VAT analysis of the acquisition and transfer of partnership interests is in essence the same as the VAT analysis of share acquisitions and transfers in respect of a company. Little attention is paid to the minutiae of the governing law of the relevant entity and it seems clear that an entity can still be a distinct "person" for VAT purposes even if it lacks legal personality (whatever that means) under its governing law. This approach makes sense because VAT is intended to be a harmonised tax applying in broadly the same way across a spectrum of EU Member States with very different domestic legal traditions.

Furthermore, Sections 45-6 VATA, where they apply, are the opposite of "look through" rules: they create a single enduring person registered for VAT in cases where otherwise (e.g. in relation to a partnership) it would be necessary to change VAT registrations on a regular basis because of changes in entity membership. At the very least, this would be cumbersome.

The VAT grouping rules largely disregard group members (other than the "representative member"). However, this is a very specialised example, mandated by EU law, of ignoring an entity for VAT simplification purposes. It does not significantly alter the overall approach, for VAT purposes, of not "looking through" business entities. Member States have considerable discretion to limit this disregard in order to prevent tax avoidance. In any case, it has little or nothing to do with the factors which classically underlie "tax transparency": namely, whether the nature of an interest in an entity or arrangement (viewed in isolation) justifies taxation at member level only. Instead, the entity disregard for VAT grouping purposes is an optional business facilitation measure.

5.5 Stamp Duty and "Tax transparency"

Stamp duty is a tax on the documentation giving effect to certain transactions. Since December 2003, its scope has been limited to certain transactions (especially transfers on sale) relating to "stock" or "marketable securities", and in some cases partnership interests[523]. Before that date, it had also applied to transfers of interests in land and to the grant of leases. Those transactions are now subject instead to Stamp Duty Land Tax ("**SDLT**") which is discussed further at 5.7.

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[521] See in particular Sections 43AA to 44 VATA, Schedule 9A VATA and the VAT (Groups: eligibility) Order 2004 SI 2004/1931.

[522] It is discussed in some detail in VAT Notice 700/2: Group and divisional registration, which was last updated by HMRC in March 2019.

[523] See Section 125 and paragraphs 31-33 Schedule 15 Finance Act 2003 ("**FA 2003**").

5.5.1 *Stamp duty and partnerships*

Historically, for stamp duty purposes, there was no question of "looking through" to the underlying assets of the partnership. In short, they were "non-transparent". Hence stamp duty was payable at standard rates on a document transferring a partnership interest on sale, without reference to the partnership's underlying assets. The rationale for this is set out in para STSM091040 (accessed 22 June 2020) of the HMRC Stamp Taxes on Shares Manual as follows:

> "A partnership interest or share is, in law, a separate item of 'property' in its own right. A partner cannot claim to be the owner of any particular partnership asset, nor of any specific share of a partnership asset. Rather, a partnership interest represents a right to control the partnership assets and affairs for as long as the partnership lasts and, upon dissolution, a right to have the assets liquidated, the liabilities discharged and a division of any surplus."

This is consistent with the case law on partnership interests discussed in 5.2. However, with effect from 23 July 2004, a partial transparency regime for stamp duty applies on a transfer of a partnership interest in accordance with paragraphs 31-33 Schedule 15 FA 2003. This regime applies where the partnership assets consist of an interest in land; and/or "stock" or "marketable securities"[524]. Without paragraphs 31-33, a transfer of a partnership interest would not be subject to stamp duty at all because of Section 125 FA 2003, even if, in particular, its underlying assets included "stock" or "marketable securities". Such assets would of course still be subject to stamp duty if they were transferred on sale directly, rather than being transferred indirectly by selling the partnership interest.

Any stamp duty on the transfer of a partnership interest is charged at the (higher) general rates rather than the special 0.5% rate which applies on a direct transfer of "stock" or "marketable securities". However, paragraphs 32-33 are likely to greatly reduce any such stamp duty charge[525].

Paragraph 32 applies where the partnership property includes a "chargeable interest" in land for SDLT purposes.[526] Because such "chargeable interests" are intended to be dealt with under the SDLT regime, paragraph 32 carves them out of stamp duty, by reducing the stampable consideration for the transfer of the partnership interest. The reduction is (broadly) the market value of the "chargeable interest" in land (less any loan secured on it), multiplied by the percentage interest in the partnership which is being sold.

Paragraph 33 only imposes stamp duty where the partnership holds "stock" or "marketable securities"[527]. It limits the stamp duty chargeable to what it would be if (i) the instrument transferring the partnership share were a direct transfer of the "stock" or "marketable securities" (stampable at

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[524] Other than any stock or marketable securities admitted to trading on a "recognised growth market" but not listed on any market: see paragraph 33(8A) Schedule 15 FA 2003, together with Section 99A FA 1986.

[525] If it has not already been reduced to nil under the "certificate of value" procedure which exempts certain lower value transactions from the general rates of stamp duty (but not from the 0.5% applicable to transactions directly involving "stock" or "marketable securities").

[526] As discussed in 5.7 below, Schedule 15 FA 2003 contains detailed SDLT rules regarding transactions in relation to partnerships, where the partnership holds one or more "chargeable interests".

[527] Other than any stock or marketable securities admitted to trading on a "recognised growth market" but not listed on any market: see fn 524.

0.5%); and (b) the consideration were the market value of the "stock" or "marketable securities" (less any loan secured on them), multiplied by the percentage interest in the partnership which is being sold. For these purposes, "stock" or "marketable securities" will include non-UK "stock" or "marketable securities" held by the partnership[528].

In order to invoke paragraphs 32 and 33, the relevant instrument of transfer must be submitted to the Stamp Office in Birmingham for adjudication under Section 12 Stamp Act 1891[529].

Parties may regard the procedure in paragraph 33 as excessively cumbersome. In that case, they may choose instead to execute the unstamped instrument of transfer outside the UK and keep it there. If so, then unless and until stamped in accordance with paragraph 33, the instrument cannot be used as evidence in UK civil proceedings nor can it be effectively enforced in the UK[530]. The instrument of transfer can later be repatriated without penalty so long as it is stamped within 30 days of being brought into the UK[531]. However, interest on unpaid stamp duty will run from the date when the instrument is executed[532].

Paragraphs 32 and 33 create a partial "look through" of a partnership for stamp duty purposes, although mainly to preserve the stamp duty charge in respect of "stock" or "marketable securities" held by the partnership, when a partnership interest is transferred. Generally, however, a partnership is not "looked through" for stamp duty purposes. This is apparent where a new partner is admitted to a partnership. Provided that the incoming partner contributes cash or other assets in return for a partnership share and there is no connected withdrawal of capital by an existing partner, HMRC do not regard the transaction as a stampable sale[533]. In particular, they do not regard the incoming partner as effectively purchasing a fractional interest in any "stock" or "marketable securities" held as partnership assets[534].

The same position holds in reverse i.e. when a partnership is dissolved, which will include any partner leaving the partnership. In that case, the distribution of "stock" or "marketable securities" in proportion to the partners' interests is not treated as a stampable transfer on sale[535].

5.5.2 *Definition of a "partnership" for Stamp Duty and SDLT*

[528] Such non-UK securities would typically not be subject to stamp duty in practice if transferred directly.
[529] See paragraphs 32(9) and 33(8) Schedule 15 FA 2003.
[530] Section 14(4) Stamp Act 1891.
[531] Section 15B Stamp Act 1891
[532] Section 15A Stamp Act 1891.
[533] See paragraph STSM092020 of the Stamp Taxes on Shares Manual (accessed 22 June 2020). The position would be different if the partner being admitted paid cash or transferred assets directly to the existing partners. In that case, the new partner would be treated as having acquired a partnership interest on sale. The amount of stamp duty payable would again be subject to paragraphs 32-33. When a partnership converts into a UK LLP (which is of course a form of body corporate), there is a special stamp duty relief in Section 12 Limited Liability Partnerships Act 2000, which must be claimed by seeking Stamp Office adjudication under Section 12 Stamp Act 1891.
[534] Cf Sections 59 and 59A TCGA, which are discussed in Appendix A.
[535] Unless the distribution is in satisfaction of a debt due to the partner from the partnership; or the partner assumes a liability in return for the distribution; see paragraph STSM092050 of the Stamp Taxes on Shares Manual (accessed 22 June 2020).

For stamp duty and SDLT purposes in FA 2003, a "partnership" means[536] anything counting as a partnership under the 1890 Act; a limited partnership registered under the Limited Partnerships Act 1907; and a UK LLP, as well as "a firm or entity of a similar character to any of those mentioned above [emphasis added] formed under the law of a country or territory outside the United Kingdom". This closing language is broad, bearing in mind that a UK LLP is in fact a body corporate which is merely treated as a partnership for certain UK tax purposes. This language is also unclear. Does a "similar character" refer to tax or non-tax characteristics of the relevant non-UK entity, or indeed to both? Take the example of a Delaware limited liability company. From a non-tax perspective, this entity, and its members' interests are similar to those of a UK LLP which is a form of body corporate under UK domestic law. From a tax perspective, they are also similar: both are typically treated as "transparent" in their home jurisdictions for direct tax purposes, although such treatment can be changed by election in the case of a Delaware limited liability company: see 7.2.4.2.

Paragraph 2 Schedule 15 FA 2003 further provides that, for SDLT purposes, a "chargeable interest" in land held by or on behalf of a partnership (as defined above) is treated as held by or on behalf of the partners, even if the partnership is a legal person, or even a body corporate under the law of the jurisdiction in which it is formed. This "look through" rule is therefore quite radical in disregarding the partnership, and in envisaging that some bodies corporate can be partnerships for these purposes (although it is unclear which ones). SDLT is discussed further in relation to partnerships in 5.7, where paragraph 2 is relevant in relation to the special SDLT computation rules in Schedule 15, which limit the extent of any "look through". Paragraph 2 is itself limited in one key respect. It is irrelevant when deciding if a partnership can be "looked through" for the purposes of claiming group relief from SDLT: see 5.5.3. This can have especially odd consequences where the partnership is a UK LLP. It is strange that this "look through" rule only applies when an interest in land is held by or on behalf of a partnership.

Paragraph 3 Schedule 15 ensures that the partnership is regarded as the same partnership throughout, notwithstanding changes in partnership membership, so long as there at least one continuing member. Paragraph 4 Schedule 15 FA 2003 also provides that a partnership (as defined in paragraph 1) is not to be regarded for stamp duty or SDLT purposes as a "unit trust scheme" or an "open-ended investment company". Both of these latter entities are typically not "looked through" for stamp duty or SDLT.

5.5.3 *Partnerships and stamp duty/SDLT group relief*

Paragraphs 31-33 Schedule 15 FA 2003 set out limited circumstances in which a partnership can be treated as "transparent" for stamp duty purposes. However, these are computational provisions only, when a partnership interest is transferred. They are not a wholesale disregard of the partnership for stamp duty purposes. This is clear in relation to the rules regarding group relief. Those rules[537] exempt from stamp duty certain transfers between "associated" "bodies corporate", and there are equivalent rules for SDLT (which is it convenient to deal with here). Broadly, such bodies are "associated" if one is a direct or indirect 75% subsidiary of the other or both bodies are direct or indirect 75% subsidiaries of a third body corporate. Whether this affiliation threshold is satisfied

[536] Paragraph 1 Schedule 15 FA 2003.
[537] See in particular Section 42 FA 1930 and the equivalent SDLT rules in Schedule 7,Part 1 FA 2003.

depends primarily on the direct or indirect "beneficial ownership" by one "body corporate" of the issued "ordinary share capital" of another.

Because a UK LLP is in fact a form of body corporate[538], HMRC accept[539] that it can be the 75% beneficial owner of another "body corporate" for the purposes of stamp duty group relief. However, because members' interests in a UK LLP are not "ordinary share capital" (or indeed share capital at all), it cannot be the 75% subsidiary of another company for such purposes. Therefore no stamp duty or SDLT group relief is available on an asset transfer from a body corporate which is the parent of the UK LLP either to that LLP itself or to a third body corporate which is a subsidiary of the UK LLP. In the latter scenario, one presumably cannot "look through" the UK LLP in the same way as for corporation tax group relief purposes because there is no stamp duty equivalent of Section 1273(1)(c) CTA 2010: see Appendix A.8.

Furthermore, the limited "look through" rule in paragraph 2 Schedule 15 FA 2003 (see 5.5.2) creates further complications in relation to SDLT group relief only[540]. Paragraph 2 only treats LLP members as owning underlying LLP assets where those assets are "chargeable interests" in land, not shares. So in the example above, paragraph 2 does not treat the parent of the UK LLP as owning directly the shares of the LLP's subsidiary, so as to establish a group relationship between that parent and the subsidiary. However, if the UK LLP transfers a "chargeable interest" in land to the subsidiary, paragraph 2 does apply. The result is that the land is treated as being transferred to the subsidiary not from the UK LLP itself (with which it is grouped) but from the LLP's parent (with which it is not grouped). Hence the limited paragraph 2 "look through" denies SDLT group relief where it might be expected to apply. Paragraph 2 would not have this effect if, instead, the interest in land were merely transferred from one subsidiary of the UK LLP to another.

This places UK LLPs at a disadvantage, for no good reason, compared to general and limited partnerships formed under English law, which can (at least in practice) be "looked through" for all purposes[541]. HMRC state that because partnerships formed under English law lack legal personality, they can be "looked through" in order to determine whether "bodies corporate" form a group for stamp duty purposes. In particular, "as such the companies that are the partners of an English general or limited partnership can, **depending upon the facts** [emphasis added] be grouped with those companies that are below the partnership in the group structure." These HMRC statements are more tentative than the equivalent guidance on corporation tax group relief (see Appendix A.8). While they have practical merit[542], any "look through" sits uneasily with HMRC's accurate analysis of the nature of a partner's interest in a partnership[543]. However, if one accepts this HMRC guidance, then group relief is available for SDLT purposes where a corporate partner has, say, a 75% share in an English partnership which transfers an interest in land to another company whose shares are held by that

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538 There is no general rule deeming it to be a partnership for all stamp duty purposes, despite paragraph 1 Schedule 15 FA 2003.

539 See paragraph STSM093020 in HMRC Stamp Taxes on Shares Manual.

540 For further discussion, see Neil Warriner, Michelle Williamson and John Tolman: "Analysis – LLPs, groups and stamp taxes" [2010] Tax Journal. Issue 1053, at page 13.

541 It also places UK LLPs at a disadvantage compared to a UK private limited company, which will be unaffected by paragraph 2, Schedule 15 FA 2003 and which typically has "ordinary share capital". It can therefore be readily grouped with its parent company.

542 HMRC make similar statements in paragraph SDLTM34360 onwards (accessed 22 June 2020) of the Stamp Duty Land Tax Manual in relation to SDLT group relief, in Schedule 7 FA 2003.

543 See the extract cited in 5.5.1 from paragraph STSM091040 in HMRC's Stamp Taxes on Shares Manual.

partnership. As discussed above, no SDLT group relief would be available if the English partnership were replaced by a UK LLP.

These HMRC statements about "looking through" an English partnership for group relief purposes also do not extend to Scottish partnerships because the latter have legal personality. However, because Scottish partnerships are not "bodies corporate" (unlike UK LLPs)[544], it is also not possible to form a group for stamp duty or SDLT between a Scottish partnership and another company whose shares are wholly owned by it. It is not satisfactory that there should be such a divergent approach between Scottish and English partnerships, especially given judicial pronouncements on the need for consistent interpretation of (non-devolved) tax legislation between the two jurisdictions[545].

5.5.4 *Trusts and stamp duty*

There is no rule which requires all trusts to be automatically "looked through" for stamp duty purposes. If "stock" or "marketable securities" are held via a trust in which beneficiaries have a vested interest in both trust income and capital (i.e. a "bare trust"), then a written transfer of a beneficial interest in that trust should be regarded as stampable because it transfers a vested beneficial interest in "stock" or "marketable securities". However, the same is not true if the trust holding the "stock" or "marketable securities" is (a) one in which the beneficiaries' interests are successive, so that they lack a vested interest in trust capital; or (b) a discretionary and/or accumulation trust. Unless the trust can be "looked through" (as in the case of a "bare trust") to the underlying "stock" or "marketable securities", a transfer of a beneficial interest in it is not subject to stamp duty since December 2003.

Since February 2000, there has also been no stamp duty charge in respect of transactions involving "units" in a "unit trust"[546].

5.6 Stamp Duty Reserve Tax ("SDRT") and "Tax Transparency"

SDRT is a directly-assessable tax chargeable on certain transactions involving "chargeable securities", as defined in Section 99 FA 1986. In particular, it is charged at 0.5% on an agreement to transfer such securities[547]. Unlike stamp duty, a transaction can be subject to SDRT whether or not it is documented.

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[544] See fn 41.
[545] See 2.9.6. As it so happens, SDLT no longer strictly applies in Scotland and Wales. Land and Buildings Transaction Tax applies in Scotland from April 2015 and Land Transaction Tax applies in Wales from April 2018. In each case, there are transitional provisions. Both these devolved taxes are, however, largely inspired by SDLT.
[546] See paragraph 1 Schedule 19 FA 1999. There was previously such a charge under Sections 54-7 Finance Act 1946. For those purposes, a "unit trust" was defined in essentially the same way as for the purposes of the direct tax legislation (see 4.3.6.1), including carve-outs for, in particular, "limited partnership schemes", "approved profit sharing schemes" and certain employee share ownership plans: see Stamp Duty and Stamp Duty Reserve Tax (Definitions of Unit Trust Scheme) Regulations 1988 SI 1988/268 (as amended). Those Regulations are still relevant for stamp duty reserve tax purposes. The carve-out for "limited partnership schemes" only applies to a UK limited partnership. On general principles, a partnership with separate legal personality (e.g. in Scotland) should not give rise to a "trust" and hence cannot be a "unit trust" anyway.
[547] See Section 87 FA 1986. Section 92 FA 1986 sets out the main conditions for ensuring that the same transaction does not give rise to both a SDRT and a stamp duty charge.

The main definition of "chargeable securities" is in Section 99(3) FA 1986, namely:

"(a) stocks, shares or loan capital;
(b) interests in, or in dividends or other rights arising out of, stocks, shares or loan capital;
(c) rights to allotments of or to subscribe for, or options to acquire, stocks, shares or loan capital; and
(d) units under a unit trust scheme."

This definition[548] does not readily apply to an interest in a partnership, whether or not that partnership owns stocks, shares or loan capital. Were the partnership to be heavily, or indeed solely invested in stocks, shares or loan capital, then one might argue that a partnership interest was an "interest in" such underlying investments, within Section 99(3)(b). However, the author is not aware of HMRC having argued this for SDRT purposes[549]. This may be because of how HMRC analyse an interest in a partnership: see 5.5.1[550]. Section 99(3)(b) FA 1986 should cover a vested beneficial interest either in stocks, shares or loan capital held on trust, or in the rights to income attaching to them.

Where a trust is a "unit trust scheme", Section 99(3)(d) also applies. For these purposes, a "unit trust scheme" is defined in much the same way as for income tax purposes[551]. A unit in a "unit trust scheme" also potentially falls within Section 99(3)(b) FA 1986. However, in practice, in such cases, one would expect HMRC to apply only the specific SDRT rules relating to units in a "unit trust scheme". Such a unit is prima facie a "chargeable security" regardless of the underlying trust property. Nevertheless, Section 99(5A)(b) and (5B) FA 1986 treat units in a unit trust scheme as not being "chargeable securities", where that scheme is only invested, in particular, in investments which are outside the charge to stamp duty and SDLT. To this limited extent, one can "look through" the unit trust to its underlying investments, when deciding whether units are subject to SDRT.

A further illustration of the partial "transparency" of unit trust schemes for SDRT purposes is Section 90(1B) FA 1986. This removes the 0.5% charge "as regards an agreement to transfer trust property to the unit holder on the surrender to the managers of a unit under a unit trust scheme if the unit holder is to receive only such part of each description of asset in the trust property as is proportionate to, or as nearly as practicable proportionate to, the unit holder's share." In short, on its surrender (but not on sale to a third party), the unit is treated as equivalent to one or more fractional interests in each of

548 This is the basic definition but there are a number of important exceptions to it in Section 99 FA 1986, not least where the relevant stocks, shares or loan capital are issued by non-UK persons. Those exceptions are not considered further in this discussion.

549 In other contexts, HMRC take a different approach. The employment-related securities rules in Part 7 ITEPA 2003 can apply to "units in a collective investment scheme": see Section 420(1)(e) ITEPA 2003. The published guidance in the Employment-Related Securities Manual at ERSM20170 states that where a partnership is a collective investment scheme, one should not usually "look through" to its underlying assets. However, it is appropriate to "look through" where the partnership invests in so-called "restricted securities"(whose value is reduced by restrictions such as forfeiture provisions) in order to apply the special "restricted securities" tax rules in Chapter 2, Part 7.

550 If the partnership is a legal person, it is harder to argue that a partnership share is an "interest in" the underlying investments of the partnership. However, this risks creating different outcomes depending on whether a partnership is an English or Scottish partnership: SDRT applies to the entire UK.

551 See paragraphs 14-19 Schedule 19 FA 1999, as well as, in particular, SI 1988/268 supra.

the underlying scheme assets. Hence if the unitholder receives on surrender those underlying fractional interests, there is no SDRT charge.

FA 2014 repealed[552] the special rules in Part II Schedule 19 FA 1999 which imposed SDRT on the surrender of units in a unit trust. Those rules were introduced in 2000.

5.7 Stamp Duty Land Tax ("SDLT") and "tax transparency"

SDLT was introduced by Part 4 FA 2003 as a replacement for stamp duty in relation to transactions involving UK real estate. Its scope is broader than that of stamp duty pre-FA 2003. In particular, it is a directly assessable tax which is not a tax on legal documentation. Slightly different variants of the SDLT legislation apply in Scotland and in Wales, via the legislation devolving certain powers to those parts of the UK. The specifics of the Scottish and Welsh regimes are not discussed here[553].

5.7.1 *SDLT and Trusts*

Section 105 and Schedule 16 FA 2003 deal with how SDLT applies to trustees, subject to the special rules regarding "unit trusts" which are discussed below. Paragraph 1 Schedule 16 draws a distinction between "settlements" and "bare trusts". The latter are defined[554] in a manner which closely resembles Section 60 TCGA.

Paragraph 3 sets out a partial "look through" regime in relation to "bare trusts" for SDLT purposes. In particular:

> "(1) Subject to subparagraph (2), where a person acquires a chargeable interest [in UK land] or an interest in a partnership as bare trustee, [SDLT] applies as if the interest were vested in, and the acts of the trustee in relation to it were the acts of, the person or persons for whom he is trustee.
> (2) Subparagraph (1) does not apply in relation to the grant of a lease.
> (3) Where a lease is granted to a person as bare trustee, he is treated for the purposes of [SDLT], as it applies in relation to the grant of the lease, as purchaser of the whole of the interest acquired.
> (4) Where a lease is granted by a person as bare trustee, he is to be treated for the purposes of [SDLT] as it applies in relation to the grant of the lease, as vendor of the whole of the interest disposed of."

For "settlements" (i.e. all trusts other than "bare trusts", as defined in paragraph 1 Schedule 16), paragraph 4 Schedule 16 FA 2003 provides:

> "Where persons acquire a chargeable interest or an interest in a partnership as trustees of a settlement, they are treated for the purposes of [SDLT], as it applies in relation to that acquisition, as purchasers of the whole of the interest acquired (including the beneficial interest)."

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[552] With effect from 30 March 2014.
[553] Land and Buildings Transaction Tax applies in Scotland from April 2015 and Land Transaction Tax applies in Wales from April 2018. In each case, there are transitional provisions.
[554] See paragraphs 1(2)-(4) Schedule 16 FA 2003 and *Pollen Estate Trustee Company Ltd v HMRC* [2013] STC 1479. The assets of any such trust will consist of one or more interests in UK land, so the operation of the "look through" rules regarding such trusts for SDLT purposes may be limited by *Crowe v Appleby* [1975] 3 All ER 529: see 4.3.2.1.

Hence, there is no SDLT "look through" in relation to a trust which is a "settlement" and which acquires an interest in land. This is true whether or not there is a vested interest in possession in the trust income.

The same non-"look through" approach applies in relation to those trusts which qualify as unit trusts, even if they would otherwise be "bare trusts". Section 101(1) FA 2003 provides in particular that SDLT applies to a "unit trust scheme"[555] "as if the trustees were a company[556]; and the rights of the unitholders were shares in the company." Therefore, if the trust is a "unit trust scheme", it is non-"transparent" for SDLT purposes, even if its assets include one or more "chargeable interests" in UK land. This partly explains why investments in UK land via Jersey property unit trusts (**"JPUTs"**) have been popular: there is no SDLT in respect of a transfer of units nor is there any SDRT or (in practice) stamp duty on such a transfer, because units in the JPUT will be registered in a register of ownership kept outside the UK.

This approach in respect of unit trusts should be contrasted with the rules regarding partnerships owning interest in UK land, which are discussed below[557].

5.7.2 *SDLT and partnerships*

Schedule 15 FA 2003 sets out quite complex rules governing the SDLT treatment of certain transactions involving partnerships. This is especially true where there is a transfer of a "chargeable interest" in land to or from the partnership; or where there is a transfer of an interest in a partnership[558]. The definition of "partnership" for SDLT purposes has already been discussed at 5.5.2. In particular[559], a "partnership" is not a "unit trust scheme" for SDLT purposes, so Section 101 FA 2003 is not relevant. The definition of "partnership" is also broad enough to embrace certain "bodies corporate", which cuts across the general SDLT approach of not "looking through" companies. There is a tension here because the definition of "company" in Section 100(1) FA 2003 excludes a "partnership", but the definition of "partnership" is broad enough to cover some companies which are akin to UK LLPs in particular.

5.7.3 *Transfer of a "chargeable interest" to a partnership*

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555 As defined in FSMA: see Section 101(4) FA 2003.

556 This deemed company status does not, however, entitle the unit trust scheme to certain reliefs, such as SDLT group relief, in Schedule 7 FA 2003: see Section 101(7) FA 2003. Section 100(1) FA 2003 makes clear that a "company" for SDLT purposes includes an unincorporated association but excludes a partnership.

557 The non-"look through" approach is also applied by Section 102A FA 2003 to the species of "tax-transparent" collective investment schemes known as "co-ownership authorised contractual schemes": see Section 235A FSMA. They are not trust-based and hence are not unit trusts. They are also not partnerships although similar to an investment limited partnership. Indeed an "authorised contractual scheme" can be set up as a limited partnership (rather than as a purely contractual arrangement), in which case it will be treated as a partnership for SDLT purposes.

558 In that case, Part 3 of Schedule 15 FA 2003 potentially applies. The transfer of a "chargeable interest" in land will include the grant, creation or variation of such an interest, as well as its surrender or release: see paragraph 9(2) Schedule 15 FA 2003.

559 See paragraph 4 Schedule 15 FA 2003.

There are special rules[560] where a "chargeable interest" in land is transferred to a partnership by an existing partner; by someone who thereby becomes a partner; or by a person "connected" with an existing or incoming partner. These rules can apply where the partnership already exists or is being formed. What follows is a summary of those rules.

The aim is to impose SDLT on that part of the market value of the "chargeable interest" which is not attributable post-transfer to the partnership share[561] of the person who made the transfer and/or a partner "connected" with that person[562]. In other words, SDLT only applies to that economic slice of the value of the "chargeable interest" which has been given to partners other than (i) the person making the transfer to the partnership or (ii) persons "connected" with that transferor. Unlike a company or "unit trust scheme", the partnership is therefore "looked through" so as to treat the person making the transfer, or a person "connected" with that person, as effectively continuing to own a slice of the contributed chargeable interest via their ongoing partnership share. The precise taxable amount is given by the formula[563] MV multiplied by (100-SLP)%, where MV is the market value of the interest transferred and SLP is the "sum of the lower proportions"[564].

Under paragraph 12A Schedule 15, a "property-investment partnership" ("PIP") can elect irrevocably to disapply paragraphs 10-12. A PIP is one whose "sole or main activity is investing or dealing in chargeable interests (whether or not that activity involves the carrying out of construction operations on the land in question)"[565]. If this election is made, the transfer of the "chargeable interest" to the partnership is subject to SDLT in the normal way on the full market value of what is transferred: the "look through" formula in paragraphs 10-12 (based on market value discounted by the "sum of the lower proportions") is then irrelevant. Making the election can have advantages for the PIP in relation to subsequent transactions, notably in relation to interests in the PIP itself which could otherwise trigger SDLT: see 5.7.4. To make the election worthwhile, the SDLT saved on those later transactions must exceed the extra SDLT incurred upfront, as a result of making the paragraph 12A election.

5.7.4 *Transfer of interest in a "property-investment partnership"*

Subject to specific exceptions, the acquisition of an interest in a partnership does not give rise to a chargeable transaction for SDLT purposes, even if the partnership property includes land[566]. Hence there is no comprehensive "look through" treatment of partnerships for SDLT purposes, in contrast for example to their capital gains tax treatment (see Appendix A, where the pitfalls of a comprehensive "look through" are discussed).

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[560] Paragraphs 10-12 Schedule 15 FA 2003.
[561] A person's partnership share is the proportion in which he is entitled at that time to share in the income profits of the partnership: see paragraph 34(2) Schedule 15 FA 2003. This is odd because partner's commercial entitlements to "chargeable interests" owned by the partnership may in fact be measured differently to their entitlement to its income profits.
[562] The definition of "connected" persons is taken from Section 1122 CTA 2010 with certain modifications. In particular, paragraph 39(2) of Schedule 15 disapplies Section 1122(7) CTA 2010, which in many cases treats partners as automatically connected with one another. Continuing to apply Section 1122(7) would undermine what paragraphs 10-12 Schedule 15 are trying to achieve.
[563] See paragraph 10(2) Schedule 15 FA 2003.
[564] The detailed rules for determining SLP are in paragraph 12 Schedule 15 FA 2003.
[565] See paragraph 14(8) Schedule 15 FA 2003. A PIP should not include, say, a partnership owning and running a hotel. Nor in practice should it include a partnership whose main profit-making activity is developing property.
[566] See paragraph 29 Schedule 15 FA 2003.

Paragraph 14 Schedule 15 is one of those specific exceptions[567]. It subjects to SDLT the transfer of an interest in a "property-investment partnership", where the "relevant partnership property" includes a "chargeable interest" in UK land. Paragraph 14 is therefore a limited "look-through" to the underlying real estate assets of the partnership. SDLT is applied to a percentage of the market value of the "relevant partnership property"[568]. That percentage corresponds to the partnership share transferred (if the person acquiring it was not previously a partner) or the increase in that person's partnership share (where the acquirer was previously a partner).

5.7.5 *Transfer of interest in a partnership pursuant to earlier arrangements*

Even if the partnership is not a "property-investment partnership", a transfer of an interest in it can trigger a SDLT charge under paragraph 17 Schedule 15. This will apply where the transfer of the interest takes place pursuant to "arrangements" in place when there was a previous transfer of a "chargeable interest" in land to that partnership. That prior transfer must itself have been subject to the restricted SDLT charge under paragraphs 10-12 Schedule 15, discussed at 5.7.3. The SDLT charge on the later transfer is a proportion of the market value (at the time of the later transfer) of the chargeable interest which was previously transferred to the partnership. The proportion reflects the extent to which the transferor's partnership share drops when the partnership interest is later transferred. In effect these rules tax a two-step realisation of the value of the underlying interest in land, firstly by transferring it to a partnership under paragraphs 10-12 and then disposing of an interest in that partnership.

A similar rule in paragraph 17A Schedule 15 applies where there is a transfer of a "chargeable interest" in land to a partnership; that transfer falls within paragraphs 10-12 Schedule 15; and a "qualifying event" occurs within three years of that transfer of land[569]. "Qualifying events" broadly consist of extracting value[570] from the partnership either by reducing a partner's capital account/partnership interest or by securing repayment of a loan made to the partnership by the person in question. SDLT is imposed on the value extracted. However, the SDLT charge is reduced to the extent that the value extracted is greater than the market value of the "chargeable interest" in land when it was transferred to the partnership. This adjustment reflects the overall aim of paragraph 17A: to impose SDLT on an indirect realisation of the value of the underlying interest in land, after it has been transferred to a partnership with the benefit of paragraphs 10-12.

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[567] The others are paragraph 10 Schedule 15 (discussed at 5.7.3 above) and paragraph 17 Schedule 15 (discussed at 5.7.5 below).

[568] The meaning of the "relevant partnership property" varies depending on whether or not the partnership interest acquired has been directly or indirectly paid for by the person acquiring it. In any case (see paragraph 14(5) and 14(5A) Schedule 15), "relevant partnership property" will exclude, in particular, any "chargeable interest" transferred to the "property-investment" partnership in return for the transfer of the partnership interest; certain leases granted at a market rent; and any underlying "chargeable interest" which is not attributable under the partnership agreement to the partnership interest which is being transferred. In some cases, "relevant partnership property" will also not include a "chargeable interest" transferred to the partnership subject to an election under paragraph 12A Schedule 15: see 5.7.3.

[569] Paragraph 17A does not apply if an election has been made in respect of the transfer of land to the partnership under paragraph 12A Schedule 15. In that case (see 5.7.3), SDLT on that transfer will not be reduced in the first place under paragraphs 10-12.

[570] However, extracting value which represents "income profit" does not trigger paragraph 17A.

The amount of any paragraph 17A charge is reduced by the amount of any concurrent charge under paragraph 14: see 5.7.4.

5.7.6 *Transfer of a "chargeable interest" in land from a partnership*

Paragraphs 18-24 Schedule 15 deal with the converse situation to paragraphs 10-12: namely, where a "chargeable interest" in land is transferred from a partnership to a present or former partner, or to a person "connected" with a present or former partner. SDLT is imposed on the market value of the "chargeable interest" transferred, multiplied by (100-SLP) %[571]. As before, "SLP" means the "sum of the lower proportions" but this time computed according to paragraphs 20-24.

The aim is to ensure that SDLT is not charged to the extent that the "chargeable interest" is being transferred from the partnership to a partner or to certain persons[572] "connected" with that partner. Effectively the rules "look through" the partnership to treat that partner or "connected" person as already owning part of the underlying "chargeable interest", to the extent of the relevant partnership share. There is no SDLT to the extent of that "pre-owned" part (cf the capital gains tax equivalent in Section 3 of SP D12, discussed in Appendix A). Paragraph 21 ensures that this "look through" does not apply (and hence more SDLT is due) unless the transfer of the "chargeable interest" to the partnership[573], and certain subsequent increases in the relevant partnership share, previously attracted stamp duty or SDLT. Hence the "chargeable interest" cannot be extracted from the partnership with no or less SDLT if it has not been put into the partnership in a way which previously triggered stamp duty or SDLT.

Paragraph 24 applies if a "chargeable interest" is transferred from a partnership when all the partners are bodies corporate. If that is the case and SLP is at least 75, SDLT is charged on the entire market value of the "chargeable interest" transferred, with no discount by reference to SLP. However, if the partners are bodies corporate within a group for SDLT purposes, then group relief may be available under Schedule 7 FA 2003[574], whether or not the entire market value of the transferred interest is subject to SDLT. Group relief can potentially apply because of paragraph 2 Schedule 15 FA 2003. This (see 5.5.2) will treat the partners in the partnership as each transferring an appropriate share of the underlying "chargeable interest" which is being transferred out of the partnership.

5.7.7 *Anti-avoidance*

The courts are alert to attempts to use the "transparency" approach of Schedule 15 FA 2003 for avoidance purposes, bearing in mind that it is quite mechanistic. As the Court of Appeal said, approving an earlier statement of the Upper Tribunal:

> "Schedule 15 should be read, construed and applied in the context of the SDLT legislation as a whole, and should not be treated as if it formed some sort of legislative island all by itself[575]"

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[571] An irrevocable election under paragraph 12A overrides these rules.
[572] In particular, individuals and certain companies acting as trustee of the "chargeable interest" and mentioned in paragraph 20(3) Schedule 15.
[573] Assuming the "effective date" of that transfer was after 19 October 2003.
[574] As modified by paragraph 27 Schedule 15 FA 2003.
[575] See Lewison LJ in *DV3 RS Ltd Partnership v HMRC* [2013] STC 2150 at 2157.

In that case, an attempt to avoid SDLT based in part on paragraph 10 Schedule 15 failed, because, under the relevant statutory fictions being invoked by the taxpayer, there was in fact no transfer of a “chargeable interest” by a partner to a partnership, as required to trigger paragraphs 10-12.

The breadth of the SDLT general anti-avoidance rule in Sections 75A-75C FA 2003 has been confirmed by the Supreme Court in *Project Blue Ltd (formerly Project Blue (Guernsey) Ltd) v HMRC*[576]. This also needs to be borne in mind when relying on Schedule 15[577]. In addition, if Section 75A bites so as to reconstitute a number of steps as a single notional land transaction subject to a higher SDLT liability, the special SDLT computation rules for partnerships in Schedule 15 FA 2003 do not apply to that notional transaction[578].

5.8 Conclusion on different types of “transparency”

This chapter illustrates how the term “tax transparency” in UK tax law is in fact a number of distinct, if related ideas, which have often evolved independently of each other. These all address the extent to which the tax treatment of a person holding an interest in an entity or arrangement should be the same as if that person had a direct interest in the underlying activities and assets of that entity or arrangement. Furthermore, this chapter shows how the concept of "tax transparency" is often less radical than some might argue. Hence it is applied in a much more limited way to those UK taxes which are not taxes on income and capital gain. In particular, there are fewer cases when an entity or arrangement is "looked through" so as to tax those with an interest in the entity or arrangement as if they were carrying on its underlying activities directly, or at least as if they had a direct interest in those underlying activities. Generally, the relevant tax rules have evolved piecemeal and are fact-sensitive. There is no one theme underlying their evolution. Rules have even developed for particular taxes without taking proper account of other rules governing the same tax (notably, the IHT “settlement” rules). This can cause confusion and lead to sub-optimal outcomes.

In relation to VAT, the concept of "tax transparency" has especially little role to play. This is most noticeable in relation to the VAT treatment of partnerships: a type of business entity which has been classically regarded for UK income and capital gains tax purposes as "flow through". This is not so for VAT, which characterises a partnership interest as an intangible asset distinct from the underlying partnership assets. This characterisation strongly resembles the way in which VAT analyses a shareholding in a company. By way of exception, the VAT grouping rules are a clear, but limited example of "looking through" certain entities entirely. This is purely because of the wording of Article 11 of Directive 2006/112, which merely empowers Member States to create grouping rules. It does not detract materially from the general point made about VAT and “tax transparency”.

For IHT purposes, the concept of "tax transparency" plays an increasingly limited role. Partnerships can be "looked through" so as to tax transactions undertaken by the partnership as if undertaken by the partners. The same is true of so-called "close companies". In the latter case in particular, partial

[576] [2018] STC 1355.
[577] SDLT also falls within the scope of the wider UK general anti-avoidance rule in Sections 206-215 Finance Act 2013, although in some respects Section 75A-C FA 2003 are wider, not least because they do not require proof of a tax avoidance purpose nor that any “double reasonableness” threshold is crossed.
[578] Section 75C(8A) FA 2003, as applied in *Hannover Leasing Wachstumswerte Europa Beteiligungsgesellschaft mbH v HMRC* [2019] SFTD 1231. .

"look through" rules ensure that companies (which are not normally liable for IHT) cannot be used by individuals and trustees with an interest in them, so as to avoid IHT. These are essentially anti-avoidance rules, although it is not necessary to demonstrate an avoidance motive to trigger them. This may expose these rules to challenge under EU law, given the EU law-driven changes to the capital gains tax “close company” apportionment rules in Sections 3-3G TCGA.

A "look through" approach is adopted for IHT purposes in respect of those simpler co-ownership arrangements which are not characterised as "settlements". This approach is shared with income tax and capital gains tax, as well as stamp duty, SDRT and SDLT but with one important difference: the concept of a "unit trust scheme" (often treated as opaque, save for income tax) has no relevance for IHT. Furthermore, IHT has a broad concept of "settlement" which covers more than trusts (including some corporate bodies and other commercial arrangements). Confusingly, it does not mean the same thing as a “settlement” for income tax or capital gains tax. The IHT “settlement” rules overlap confusingly in terms of the entities which they cover with the IHT "close company" rules mentioned above. Furthermore, their approach is very different from those close company rules. In particular, since 2006,"settlements" are increasingly subject to a fairly harsh IHT regime which taxes them as separate entities, taking no account of the tax profile of the “settlement” beneficiaries but taking some account of the tax profile of the settlor. This non-"transparent" approach further complicates the confusing IHT overlap between "settlements" and "close companies" because the "close company" rules invariably adopt a form of "look through" treatment.

For the purposes of stamp duty, SDRT and SDLT, arrangements and entities tend (apart from "bare trusts") not to be "looked through" for tax purposes. This is especially true of companies and "unit trust schemes", even though the latter are in essence a form of "bare trust". Yet there are exceptions where a qualified "look through" approach is permitted. In the case of partnerships, those exceptions are quite elaborate (especially for stamp duty and SDLT). However, for stamp duty purposes, the partnership “look through” is a limited anti-avoidance device while the SDLT “look through” deliberately falls well short of treating partnerships as “look through” whenever they engage in transactions involving real estate. In that respect, it differs from the capital gains tax approach to partnerships in Sections 59-59A TCGA and thereby avoids a number of complications for partners generated by that approach. The definition of "partnerships" for stamp duty and SDLT purposes is problematic. In particular, it includes some entities (notably UK LLPs) which in essence are private companies. This reflects the extent to which the commercial concept of a “partnership” has changed but is also confusing: “partnerships” can sometimes be subject to stamp duty and SDLT on a "look through" basis whereas companies cannot. The ability to switch between different types of corporate entity to achieve a desired tax outcome will not be lost on taxpayers and their advisers.

Finally, when deciding whether a group relationship exists between two companies for UK tax purposes, it is very doubtful technically whether the "transparency" of a partnership allows the required degree of affiliation to be traced through a partnership which is interposed between those two companies. It is clear that HMRC sometimes take a more generous approach in practice and it would be much better if this practice were clearly codified, with proper safeguards against avoidance. However, the status quo show how, for UK tax purposes, "transparency" typically does not mean totally disregarding an entity or arrangement, even if it is not taxed in its own right but only at the level of its members. “Transparent” entities or arrangements are rarely, if ever, tax “nothings”.

6. The UK classification of entities and the significance of "tax transparency" as it relates to the UK's double taxation treaties and EU law

6.1 Introduction and Article 1(2) OECD Model Tax Treaty 2017

The UK has a very extensive network of double taxation treaties ("**treaties**") which are mainly modelled on various versions of the OECD's Model double taxation agreement ("**the OECD Model**")[579]. Cross-border transactions are especially likely to highlight differences between the UK approach to classifying entities for tax purposes and the approach of other jurisdictions. Similarly such transactions often highlight differences between the UK and other jurisdictions regarding whether arrangements are "tax transparent" or not and, if so, what this signifies.

Such differences have of course been actively exploited in order to avoid tax. To give a simple example, one jurisdiction ("**A**") may be prepared to give treaty relief at source in respect of royalty income paid to an entity in another jurisdiction ("**B**") which it regards as "transparent" (e.g. a partnership) and all of whose members are individuals resident for tax purposes in B. From A's perspective, income is treated as being currently paid to individual taxpayers resident in B, whether or not the entity distributes that income to its members. However, if B in fact regards the same entity as both non-taxable in its own right and non-"transparent", then the income relieved at source in A may in fact escape current taxation in B, both at the level of the entity and of its members. Because of the differing perspectives of A and B, there is therefore a risk of double non-taxation (or at last under-taxation), whereas the general aim of a treaty should instead be to avoid both double taxation and unintended double non-taxation. Mismatches of this kind are of course the target of Action 2 of the BEPS project[580]. Of course, such situations can also create a risk of double taxation contrary to the aim of a treaty. To reverse the example above, if A regards the payee of royalties as a non-taxable entity, then the risk arises that it will refuse treaty relief even though B regards that entity as a partnership so that its royalty income is currently taxable in the hands of its members who are residents of B.

As discussed in 5.2, the new Article 1(2) of the OECD Model goes some way to addressing these double taxation issues. The UK has been regularly negotiating language along the lines of Article 1(2) in recently-concluded treaties[581]. Furthermore, as discussed in 5.2, the UK is a party to the MLI which

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[579] For the most recent version of the OECD Model, see the Model Taxation Convention on Income and Capital 2017, dated 21 November 2017 and the accompanying Commentary ("**the OECD Commentary**") http://www.oecd.org/ctp/model-tax-convention-on-income-and-on-capital-full-version-9a5b369e-en.htm. (accessed 23 June 2020). This version includes significant changes in the wake of the OECD's work on BEPS, including changes regarding treaties and "tax transparency", which have already been mentioned in 5.2 and which will be considered further in this Chapter.

[580] Action 2 has been partly embodied in UK domestic law by the extensive "hybrid mismatch" rules in Part 6A TIOPA. At EU level, Articles 9 to 9b of Directive 2016/1164 (as modified by Directive 2017/952) set out how the principles of Action 2 are to be given effect in the domestic law of Member States. This necessitated some limited changes to Part 6A TIOPA, taking effect from 2020. A discussion of these rules, which focus on curbing double non-taxation, is beyond the scope of this thesis. However, while extensive, and in some respects broader than the Action 2 recommendations, they by no means cover all potential situations giving rise to double non-taxation arising from hybrid mismatches, not least because they only apply to UK taxpayers subject to corporation tax. They also do not generally disturb the underlying UK tax architecture on entity classification and the meaning of "tax transparency".

[581] One example is Article 4(3) of the UK-Uruguay double tax treaty signed on 24 February 2016 and entering into force on 14 November 2016 (SI 2016/753). Another example is the new Article 1(2) of the UK-Uzbekistan

is now in force in the UK[582]. Article 3(1) of the MLI is in essence the same as Article 1(2) of the OECD Model and, generally, subsequent references to Article 1(2) should be read as including Article 3(1).

Generally, the UK adopted the Article 3 provisions on "transparent entities"[583]in its list of notifications and reservations, when it deposited its instrument of ratification of the MLI. However, some UK treaties which already contained bespoke wording regarding "transparent entities" (notably, the UK-France and UK-Netherlands treaties) have, unusually, not been modified by Article 3(1) of the MLI. Those treaties are discussed later in this Chapter.

Article 1(2) is very much a compromise which does not, in particular, seek to impose on treaty parties common entity classification standards. Furthermore, it has weaknesses discussed below. However, it represents the current, and most advanced, UK position on how tax treaties should address the allocation of taxing rights where "transparent" entities are involved and especially where the parties to the treaty do not agree on entity classification. The UK position is therefore substantially in line with the post-BEPS thinking as reflected in the OECD Model and MLI. This chapter considers how the UK got to this position and, in particular, the impact of the current UK-US double tax treaty, which largely foreshadowed Article 1(2). Generally, the UK (unlike the US) has not led the debate in this area and has historically tended to address such entity classification issues in detail in its treaties where concerns have been raised by its treaty partners (notably, the US, France and the Netherlands).

As already mentioned, the strengths and weaknesses of Article 1(2) of the OECD Model and Article 3(1) of the MLI have been extensively analysed[584]. Without repeating that analysis in detail, it is helpful to summarise some key points, before turning to the evolution of UK treaty policy in this area:

6.1.1 Article 1(2) only sets a minimum standard. In particular, it only addresses whether a source state should grant treaty relief in respect of source state income paid to or earned by an entity which is regarded as "transparent" by either contracting state. That entity can be in a third state. Article 1(2) does not address the situation whether that income is paid from such a "transparent" entity. Some

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treaty of 1993 (SI 1994/770), following amendment by a Protocol signed on 24 January 2018 and entering into force on 1 June 2018.

582 http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm (accessed 23 June 2020). The UK has begun to publish "conforming" versions of its treaties, as modified by what it and its treaty counterparties have agreed to, and reserved against, under the complex procedure for applying the MLI, a discussion of which is beyond the scope of this thesis. While these "conforming" versions are useful in understanding how the MLI has modified existing treaties, they have no binding legal authority. Ultimately, the treaty in question must be compared with the list of notifications and reservations deposited by the UK and the relevant treaty counterparty with the OECD under the MLI procedure.

583 The final list was published by HMRC on 17 July 2018: see http://www.oecd.org/tax/treaties/beps-mli-position-united-kingdom.pdf. (accessed 9 January 2020). The only part of Article 3 against which the UK has reserved is Article 3(2). This provides that one party to a treaty is not required to grant one of its residents double taxation relief in respect of its income where that treaty permits the other party to the treaty to tax that same income on the basis that it is derived by a resident of that other jurisdiction. Such a situation could, in particular, arise because of the "saving" clause in Article 11 of the MLI, which entitles a contracting state to tax its residents as if the relevant treaty did not apply (with limited exceptions). Paragraph 7.5 of the Explanatory Notes to Double Taxation Relief (Base Erosion and Profit Shifting) Order 2018 (SI 2018/630 which gives effect to the MLI in UK domestic law) states that the UK agrees with the policy underlying Article 3(2) but its wording differs from the wording of existing treaties to which it might apply. It might therefore cause uncertainty, which has led the UK to reserve its position on Article 3(2). .

584 See "Some Reflections", op. cit.

countries have chosen to negotiate treaties which go beyond this minimum standard e.g. the US – Canada treaty, whose Article IV(6) and (7) were added in a 2007 Protocol[585].

Article 1(2) only deals with the attribution of income of a "transparent" entity to those with an interest in that entity. Therefore, it does not address questions whether (notably in Article 15(2) of the OECD Model) such an entity is, or can be a "resident" of a particular state.

6.1.2 Article 1(2) allows the state of source to decide whether an item constitutes taxable income in the first place and if so, its amount and when it arises. The other contracting state has no say in these matters, even if, for example, it might regard a particular event as not giving rise to taxable income, such as a "deemed dividend".

6.1.3 As discussed in 5.2, the meaning of "fiscally transparent" for these purposes is not clear. The focus seems to be simply on whether income derived via an entity is taxable in its members' hands on (?) a current basis (whether or not distributed by the entity), and as if the underlying income of the entity had arisen directly to those members. It is unclear whether Article 1(2) applies if the entity's income is attributed to its members, or to the settlor of a trust, on a current basis, under anti-deferral rules such as "controlled foreign company" or "settlement" rules. Is this kind of scenario "fiscal transparency"? The fact that such anti-deferral rules do not always operate in the same way adds to the uncertainty[586]. It is also unclear whether Article 1(2) can operate if some prior discretionary step (other than an actual distribution) has to take place at entity level before an income entitlement can arise[587].

A related point not covered by Article 1(2) is whether treaty benefits should be granted at source even where income is derived via an entity which the source state regards as "opaque", in cases where that income would have been exempt from tax anyway in the hands of an entity member if the latter had received it directly. In modern treaties based on the OECD Model, the fact that a resident of one jurisdiction is exempt from tax in respect of certain income in its home jurisdiction does not per se prevent it claiming treaty relief from source state tax in respect of that income. For example, many pension funds can claim treaty relief from withholding tax in respect of investment income which they receive directly. If treaty relief would be granted where a tax-exempt receives income directly, it would be odd to deny treaty relief where the income is instead derived via an interposed "opaque" entity.

6.1.4 Equally unclear is whether Article 1(2) can apply if the member of the "fiscally transparent" entity is fully taxable on its allocated share of income, even if that allocated share does not have the same character and source in the member's hands as the underlying entity income. In this case, it

[585] See "Some Reflections" op. cit. at page 302.
[586] See "Some Reflections" op. cit. at pages 315-6.
[587] The authors of "Some Reflections" op. cit. at page 317 consider that such a scenario is consistent with "fiscal transparency", whereas an income entitlement which is conditional on a distribution is not so consistent, at least if that distribution is treated as a separate income source. This author agrees. For a similar argument which may in fact go slightly further, see Brabazon: op. cit, at page 208, who states that transparency should depend solely on whether income of the entity is currently attributed to an entity participant for tax purposes in that participant's home jurisdiction. If there is such current attribution, it is not relevant whether it is in fact triggered by a distribution from the entity.

seems unobjectionable in policy terms for the source state to grant treaty relief. However, this scenario is harder to describe, technically, as "fiscal transparency".

6.1.5 It is not clear how Article 1(2) (and in particular Article 3 of the MLI) affect treaties which already adopt a "partial residence" approach to certain potentially transparent entities. Such "partial residence" provisions often predate the 1999 OECD Partnerships Report, which deprecated their use. They operate, in particular, by treating a partnership or trust as resident in a contracting state, to the extent that its income is currently taxable in that state, either at entity or at member level. Hence they recognise certain prima facie "transparent" entities as wholly or partly treaty-resident. "Partial residence" provisions can sometimes be more generous (in terms of granting treaty relief) than Article 1(2) and Article 3 of the MLI.

6.1.6 Is one of the effects of Article 1(2) to treat as "beneficial owner" any member of an entity relying on it to claim source state treaty benefits? Article 1(2) does not explicitly address the question of "beneficial ownership" in, for example, Articles 10-12 of the OECD Model. However, presumably a treaty-resident which relies on Article 1(2) to claim treaty benefits in respect of income derived via an entity which is "transparent" in that taxpayer's residence state should be regarded as the "beneficial owner" unless other additional factors are in play e.g. the entity itself or the treaty-resident receives the income as nominee for a third party[588]. Otherwise, lack of "beneficial ownership" by the entity member would largely undercut the benefits of Article 1(2).

Nevertheless, this remains a point of contention, not least because the Technical Explanation of Article 11 of the US Model Treaty says that the source state should determine the question of "beneficial ownership" and the Commentary on Article 1(2) does not contradict this[589].

6.1.7 A related issue arises from the interaction between Article 1(2) and Article 10(2) of the OECD Model. The latter grants an extra reduction in the permitted withholding tax rate on dividends received by a "company" resident in one contracting state, where they arise in respect of a substantial shareholding "held directly" in a company resident in the other contracting state. Can this condition ever be satisfied where the first company has an interest in a "transparent" entity which owns the shares in the second company? In particular, is this a "direct holding"? Article 1(2) does not explicitly attribute ownership of the assets of a "transparent" entity to its members, although some treaties go further and address this issue explicitly. Furthermore, whether it is appropriate to attribute at all, and how, will depend heavily on the facts. For example, if the shares in the second company are owned by a trust in which all beneficiaries have vested, concurrent interests in trust capital and income, then one can make a better case for attributing those shares to a corporate beneficiary of the trust in proportion to its beneficial interest. It is much harder to make such a case where a trust beneficiary only has a beneficial interest in underlying trust income or, indeed, is a mere discretionary beneficiary.

It may be easier to conclude that the equivalent of Article 10(2) in a treaty applies where it merely requires the substantial shareholding to be subject to the "control" of the first company, and that shareholding is owned by a "transparent" entity in which the first company has a significant interest.

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[588] See "Some Reflections" op. cit. at pages 333-8.

[589] See Leopoldo Parada: "Hybrid Entities and Conflicts of Allocation of Income within Tax Treaties: Is New Article 1(2) of the OECD Model (Article 3(1) of the MLI) the Best Solution available?"[2018] BTR 335 at pages 350-8 (hereafter "**Parada: Article 1(2)**".

Even then, depending on the facts, it may be difficult to conclude that the first company has such "control" e.g. if it is only the income beneficiary of a trust which owns the shares[590].

6.1.8 If a "transparent" entity has a "permanent establishment" in the source state, can that establishment be attributed to those with an interest in the entity when applying Article 1(2)? Policywise, this makes sense if those interest holders are relying on Article 1(2) to claim treaty benefits in respect of income derived via that entity. Otherwise those interest holders may be in a better position in terms of claiming treaty relief at source than if they had invested directly. Yet it is unclear that Article 1(2) goes that far[591]. It is even less clear, on both policy and technical grounds, that one can attribute to the entity a "permanent establishment" in the source state which the holder of an interest in that entity may have quite independently of the entity itself.

6.1.9 Where the "transparent" entity is established in a jurisdiction which requires it to tax its own distributions to those holding an interest in it, Article 1(2) does not assist e.g. where the entity is regarded as non-"transparent" in its home state, even though those with an interest in it are resident in another state which regards that entity as "transparent". Similarly, the "saving" clause discussed in 6.1.10 does not apply because its focus is on preserving the right of the entity's home state to tax the entity itself, rather than distributions by it to the entity's members.

6.1.10 Article 1(2) sits alongside Article 1(3) which introduces into the OECD Model a "saving" clause of the type familiar for many years in treaties with the US. This preserves the right of a person's state of residence to tax that person as if the treaty were not in force, with limited exceptions. The exceptions in particular permit that person to invoke the treaty's elimination of double taxation provisions, the non-discrimination Article and the Article dealing with mutual agreement proceedings between the treaty parties. Article 11 of the MLI contains a "saving" clause which is broadly the same as Article 1(3). Alternatively, Article 3(3) of the MLI contains a short-form "saving" clause without the exceptions listed in the penultimate sentence.

Article 1(3) means that if the state where an entity is established regards it as tax-resident there (e.g on the basis that it is not "transparent"), that state can tax it. This is so even if members of that entity resident in another jurisdiction can invoke the equivalent of Article 1(2) to obtain treaty benefits in

[590] See "Some Reflections" op. cit. at pages 339 to 342. At page 366, fn 218, the authors suggest that, by contrast, there is no difficulty tracing the required corporate affiliation through a "transparent" partnership for the purposes of the EU Parent-Subsidiary Directive 2011/96/EU. Article 3 of that Directive simply refers to a "holding in the capital" or a "holding of voting rights" in the putative subsidiary. The author is not aware of this point having been addressed by the CJEU. It would be much harder to apply this reasoning to show the required level of inter-company affiliation for the purposes of the EU Interest and Royalties Directive 2003/49/EC. Article 3(b) of that Directive requires a "**direct** minimum holding" of capital or voting rights by one company in another. For a further discussion on tracing corporate affiliation through a trust for Article 10(2) purposes, see Brabazon op. cit.at pages 240-243.

[591] See "Some Reflections" op. cit. at pages 342-3, where the authors note, inter alia, that in relation to partnerships, the 1999 OECD Partnership Report indicated that a partnership's "permanent establishment" should be attributed to its partners. In *GE Capital Finance Pty Ltd v Commissioner of Taxation* (2007) 9 ITLR 1083, the Australian Federal Court declined to treat a US unit holder in an Australian unit trust as having an Australian "permanent establishment". In particular, it refused to apply an Australian rule which treated a non-Australian-resident trust beneficiary as having an Australian "permanent establishment" for treaty purposes, where a non-Australian-resident trustee had such a "permanent establishment". This type of rule is a standard feature of Australian tax treaties: see Brabazon op. cit. at page 233 and see also below the discussion of the UK-Australia tax treaty.

the state where the entity's income is sourced and which they derive through that entity. Hence the "saving" clause creates the risk that the same underlying income will be taxed twice, on the basis of residence, in the hands of two different taxpayers: the entity itself and its members.

If the entity is tax-resident in its home state, it may be entitled to treaty benefits in its own right when it receives income from another state. Any such benefits would arise under the treaty between the entity's home state and that source state. Of course the entity's members may also be seeking treaty benefits from the source state in respect of the same income. They would be relying on the separate treaty between that state and the residence state of the members, and in particular on that treaty's equivalent of Article 1(2). Following the 1999 OECD Partnership Report and consequent changes to the OECD Commentaries, in this situation the source state must apparently give tax relief under whichever of the two treaties is the more favourable. This does not of course extend to refunding the same amount of source tax twice[592]. It also does not address the risk that underlying income is taxed twice on the basis of residence because of the "saving" clause: see the previous paragraph.

One should also query whether, in the last situation, the source state should have to give treaty relief under whichever of the two treaties is the more favourable. The entity members have not invested directly in the source state but (for whatever reason) via the entity. It is one thing to say, as per Article 1(2), that the source state should not refuse them treaty relief simply because it regards the entity as "opaque" while it is "transparent" in the residence state of the members. But why should the source state go one step further and grant those members the higher level of treaty relief they would have obtained if they had invested directly, and not via the entity?

6.1.11. Article 1(2) has no direct bearing on whether the residence state of the members of an entity should give them a foreign tax credit for tax imposed on the entity itself.

Where that residence state regards the entity as "transparent", then presumably there should be little difficulty conceding a foreign tax credit so long as the foreign tax was not imposed on that entity purely because it was a resident of another jurisdiction. In other words, that tax would need to be a source-based tax on its underlying income. The position is more difficult when the members' residence state regards the entity as "opaque", even if the entity is regarded as "transparent" in its home state or the state where its income is sourced. This in essence is the situation which confronted the UK courts in *Anson v HMRC*[593].

Articles 23A and B of the OECD Model have in fact been amended to make clear that one state is not required to give double taxation relief to one of its residents for tax imposed by the other state in accordance with the treaty where that tax stems solely from residence-based taxation by the other state: see the inserted words "(except to the extent that the […] provisions [of the treaty] allow taxation by that other State **solely** [emphasis added] because the income is also income derived by a resident of that State)". The word "solely" may therefore preserve a right to some relief in the

[592] See "Some Reflections" op. cit. at pages 350-352.
[593] [2015] UKSC 44: see 2.14. In that case, the Supreme Court sidestepped the problem by concluding that the limited liability company was, on the particular facts, "transparent" in the state where the members were resident, as well as in the state where it earned its income.

residence state where the other state is entitled to tax the income in question as both local source income, and as income of a resident of that state (e.g. under an Article 1(3)-type "saving" clause).[594]

6.1.12 Article 1(2) has been rightly criticised for not protecting adequately the taxing rights of the source state. One commentator has argued that "it fails in achieving the two principal purposes of the BEPS project, which are to allocate taxing rights to states in which the economic activities generating income are carried on, and to abate unintended non-taxation of income. Not only is the provision inadequate, [but] read in conjunction with the saving clause, it also facilitates unrelieved double taxation of income in certain circumstances, in scenarios in which courts had been able to devise ways of avoiding such double taxation"[595]. The court decisions alluded to are *Anson v HMRC*[596] and *Bayfine v HMRC*[597].

This commentator in particular notes that Article 1(2) removes source state taxation rights simply because of legal fictions on "transparency" applied to the relevant entity by the contracting state in which that entity's members are resident. In some cases, those fictions may even be applied at the option of that entity's members. Furthermore, if there is active income from business activities in the source state, that state may lose the right to tax that income if the definition of "permanent establishment" is narrower in its treaty with the state in which the entity's members are resident, when compared to its treaty with the entity's state of residence[598]. The first of these criticisms is unconvincing: "opacity" and "transparency" are inherently legal fictions and the very essence of Article 1(2) is that the source state should to some extent respect the fiction prevailing in the residence state of the entity's members, if it leads to "transparency". The precise mechanics of that fiction, even it is elective, are irrelevant. The second criticism, regarding different "permanent establishment" definitions, is justified. In essence, it is the same criticism as this author made regarding differential withholding rates in 6.1.10.

Another commentator has even suggested that, for simplicity and partly to protect the source state, Article 1(2) should be replaced by a rule whereby each state accepts the tax characterisation of the entity in the state where it is "formally and legally established or incorporated"[599]. Yet that state could be a third country (including a tax haven) where the entity has little real presence. Moreover, its rules on characterising entities (if any) may radically differ from those of the source state and the state where the entity's members are resident. For example, that third country may give taxpayers a lot of freedom to choose the entity's tax characterisation from time to time. Furthermore, the rules in that

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[594] For a fuller discussion of the changes to Articles 23A and B and their implications, see Christopher Bergedahl: "Hybrid Entities and the OECD Model (2017): The End of the Road?" Bulletin for International Taxation (July 2018) 417 and especially pages 421-8.
[595] See discussion of Article 1(2) in Dhruv Sanghavi: "Structural Issues in the income tax treaty network: Towards a coherent framework". Ipskamp Printing BV, Enschede. 2018. ISBN 978-94-0280-972-5. https://cris.maastrichtuniversity.nl/portal/en/publications/structural-issue.
[596] [2015] STC 1777.
[597] [2011] STC 717. The reference to this case is strange because, as discussed in 6.4.3, the courts concluded that the UK did **not** need to give credit against tax on a UK-resident company for US tax imposed on its parent company under the "saving" clause in the then UK-US treaty. In other words, there **was** potential unrelieved double taxation.
[598] The treaty with the entity's residence state may, for example, contain an expanded definition of "permanent establishment" covering the provision of services related to activities in the putative source state. For an example of such an expanded definition, see Article 5(2)(k) of the UK-India treaty SI 1993/1801 (as amended).
[599] See Parada: Article 1(2) op. cit. [2018] BTR 335 at pages 358 et seq.

country could be changed unilaterally. It is doubtful whether either the source state or the state where the entity's members reside will want to delegate to a third country effective control over what entities it treats as taxable[600].

6.1.13 One point raised by commentators[601] is whether treaty benefits should be denied at all in the source state under Article 1(2) where the same income flow is treated as non-deductible anyway under anti-hybrid mismatch rules introduced to give effect to BEPS Action 2. To deny treaty benefits as well as a tax deduction risks overkill. Sections 187 and 187A TIOPA (in the UK "transfer pricing" rules) are a useful precedent for avoiding this kind of overkill.

6.1.14 A final point relates to practical problems in applying Article 1(2). As one commentator has put it recently: "…neither the Partnership Report nor the new OECD Commentary on the fiscally transparent entity provision [i.e. Article 1(2)] explains exactly how in practice a source country can give treaty benefits to the members of a legal entity when it taxes the entity and not the members"[602]. Applying Article 1(2) may be especially complex where one is dealing with an entity with a large and shifting cast of members. While there may be opportunities for streamlining treaty relief applications via the manager of that entity, the source state is likely to play safe, by withholding tax on income of the entity and then dealing with suitably-evidenced refund applications from entity members. The process of securing treaty relief under Article 1(2) is unlikely to be quick.

6.2 Persons: do they include partnerships and trusts?

6.2.1 *Background*

Historically, most UK treaties did not address directly the position of potentially tax-transparent entities such as partnerships or trusts, which were effectively regarded as "nothings" for treaty purposes. Events were to undermine this approach. A UK treaty will typically define the persons to which it applies in accordance with the OECD Model. Article 1(1) of the OECD Model provides that:

> "This Convention shall apply to persons who are residents of one or both of the Contracting States".

Article 3 of the OECD Model then provides that "unless the context otherwise requires":

> "(a) the term 'person' includes an individual, a company and any other body of persons [emphasis added];

[600] The same commentator has suggested that to be fully effective, all states would have to adopt the rule for classifying entities by reference to the law in their state of formation. This rule would also need to be disapplied where it incentivised entity formation in jurisdictions with advantageous tax treatment: see Leopoldo Parada: "Hybrid Entity Mismatches: Exploring Three Alternatives for Coordination" (2019) Intertax, Volume 47, Issue 1 at page 24 and in particular, parts 3.3.1 and 3.3.2. .
[601] See "Some Reflections" op. cit. (at fn 91, page 318).
[602] See Richard Vann commenting on *Resource Capital Fund IV LP v Commissioner of Taxation* 21 ITLR 655 at 660. That case is discussed further at 6.3.2. It involved two limited partnerships which were regarded as transparent in the USA but as taxable entities in their own right in Australia.

(c) the term 'company' means any body corporate or any entity that is treated as a body corporate for tax purposes".

This definition of "person" is not exhaustive (hence the word "includes"). The Commentary to the OECD Model incorporates the 1999 OECD Partnership Report ("**the Partnership Report**")[603], of which paragraph 30 stresses that a partnership is a "person" for treaty purposes either because it is "any other body of persons" or because (in some cases) it falls within the second part of the definition of "company". The Commentary, as so amended, will be relevant when interpreting "person" in any UK treaty concluded since the Commentary was amended to reflect the Partnership Report. In any case, even in respect of older treaties, the UK courts are likely, in the light of the *Padmore* decision[604] discussed below, to conclude that a "person" includes a "partnership". They are also likely to conclude that a "person" includes a trustee or a body of trustees, the latter being an "other body of persons"[605]. This should be the case even if the treaty definition of "person" is made exhaustive by replacing "includes" (as per the OECD Model) with "comprises".

6.2.2 *Padmore v IRC*

Padmore ended any perception that partnerships and trust are "nothings" for the purposes of the UK's treaties, even though its precise effects in UK domestic tax law no longer apply. In *Padmore,* a UK-resident partner in a Jersey partnership sought to rely on the old UK-Jersey treaty[606] to avoid tax on income from his partnership share. The then treaty[607] exempted the profits of a "Jersey enterprise" from UK tax provided that its business was not being conducted through a UK "permanent establishment". It was accepted that the partnership had never done business through a UK "permanent establishment". Article 2(1) defined a "Jersey enterprise" as an "industrial or commercial enterprise or undertaking carried on by a **resident of Jersey** [emphasis added]".

Article 2(1)(f) in turn defined a "resident of Jersey" as "any **person** [emphasis added] who is resident in Jersey for the purposes of Jersey tax and not resident in the United Kingdom for the purposes of United Kingdom tax". This definition did not require the "person" to be liable to tax in Jersey[608]. Hence, although the partnership was not taxable as such in Jersey[609], the courts ruled that it could be

603 https://read.oecd-ilibrary.org/taxation/the-application-of-the-oecd-model-tax-convention-to-partnerships_9789264173316-en#page1. (accessed 23 June 2020).
604 [1987] STC 36 upheld on appeal in [1989] STC 493.
605 See Philip Baker QC in "The Application of the Convention to Partnerships, Trusts and Other Non-Corporate Entities" (2002) Gray's Inn Tax Chambers Review, Volume II No. 1, page 1 at pages 15-16. The author notes that where there is more than one trustee, it is better to see the trustees as a single "body of persons", and hence a "person" for treaty purposes, rather than treating each trustee as a separate "person". In particular, this works better in terms of allocating the trust a single place of treaty residence where different trustees are resident in different jurisdictions.
606 SI 1952/1216, which has now been superseded by SI 2018/1348.
607 Article 3(2)
608 As discussed below, this definition of "residence" for treaty purposes is archaic and out of line with current practice, as exemplified by the OECD Model.
609 As in the UK, a Jersey partnership's profits are apparently currently taxable at the level of its members and and the partnership entity itself is not a separate taxpayer. The precise Jersey position at the time of *Padmore* resembled the pre-1997 UK approach to taxing partnerships. In other words, while the partnership was not a separate taxpayer and while the tax due on the partnership profits was the aggregate of the tax computed on each partner's profit share, taking account of each partner's circumstances, the tax debt in respect of those

resident in Jersey for the purposes of this particular treaty because it was, on the facts, managed and controlled there[610].

That left the question whether the partnership was a "person", rather than a "nothing". Article 2(1)(d) of the UK-Jersey treaty defined "person" to include "any body of persons, corporate or not corporate". This wording is not the same as the OECD Model to which the courts in *Padmore* did not refer. It was, however, very similar to Schedule 1 of the Interpretation Act 1978 which provides "unless the context otherwise requires", that " 'person' shall include any body of persons corporate or unincorporated". In both definitions, the closing words appear to be words of expansion. On that basis, the courts ruled that the Jersey partnership was a "body of persons", as defined, and hence a "person", not a "nothing", for the purposes of the treaty. It was therefore exempt from UK tax on its profits and so was the UK-resident partner. The courts drew no distinction for these purposes between the partnership itself and the partnership share of the partner, not least because the Jersey partnership resembled a classic English general partnership. It therefore lacked a legal personality distinct from that of the partners. Fox LJ in the Court of Appeal said[611]:

> "[The UK-Jersey treaty] relieves from United Kingdom taxation all the profits of a Jersey enterprise…..That enterprise in the present case is a partnership. The partnership is not an entity distinct from the partners. The profits belong to them. As a matter of construction….. I see no words which exclude the individual partner's share of the profits from the exemption. The exemption is in general terms and I see no reason why the greater does not include the less."

The UK tax authorities also argued that the relevant definition of "body of persons" was in fact the very old UK definition in what is now Section 118(1) TMA, as well as in Section 989 ITA and Section 1119 CTA 2010. This defines "body of persons" as "any body politic, corporate or collegiate, and any company, fraternity, fellowship and society of persons, whether corporate or not corporate"[612]. It was argued that this definition was narrower than the definition of "person" in the UK-Jersey treaty and that, in particular, it excluded partnerships. The Court of Appeal assumed that it was a narrower definition but decided that it was displaced by the specific definition of "person" in the treaty[613].

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partnership profits was assessed on and due from the partnership, with each partner being jointly and severally liable. This is discussed at first instance in *Padmore* by Peter Gibson J (as he then was), at [1987] STC 45.

[610] In reaching this conclusion, they derived support from what is now Section 857(1)(b) ITTOIA and its oblique suggestion that "control and management" is the key criterion when deciding whether a partnership has a specific place of non-UK residence (rather than just being resident "outside the UK" without specifying where). For a recent decision concluding that a partnership was controlled and managed wholly outside the UK, even though one of the two partners was UK-resident, see *Mark Higgins Rallying (a firm) v HMRC* [2011] SFTD 936. In that case, management remained in the Isle of Man although the only relevant question was whether it was situated "outside the UK" for Section 857(1)(b) purposes. No tax treaty was relevant in that case.

[611] [1989] STC 493 at 500.

[612] This early nineteenth-century definition dates back to the origins of UK income tax. It is mainly relevant when deciding which "bodies of persons" can be assessed to UK income tax (not corporation tax) under Section 71 TMA.

[613] The only basis for bringing in the old domestic law definition of "body of persons" would have been that a "body of persons" was an otherwise undefined term and hence a reference to domestic law was appropriate under Article 2(3) of the UK-Jersey treaty. The courts decided that "body of persons" in this treaty was not an otherwise undefined term. Even if it had been, John Avery Jones has argued (see [1990] BTR 453) that the context indicates that the relevant UK domestic law definition for the purposes of Article 2(3) is not Section 118(1) TMA but rather, the definition of "person" in Schedule 1 Interpretation Act 1978, which closely resembles the definition of "person" in the UK-Jersey treaty. He has also argued that the Section 118(1)

Article 3 of the OECD Model and the Commentary on it (in particular paragraph 2) are consistent with *Padmore.* In particular, Article 3(1)(a) provides that "unless the context otherwise requires", "the term 'person' includes an individual, a company and any other body of persons". The Commentary notes that a partnership will for these purposes either be a "company" or an "other body of persons".

The effect of *Padmore* in exempting the UK-resident partner from tax on the partnership share was reversed retrospectively by what is now Section 858 ITTOIA. That legislation[614] also overrode the UK's treaties. It was further expanded in 2008 to counter arrangements whereby UK-resident persons tried to rely on *Padmore* by investing in a non-UK partnership indirectly via a trust, rather than directly[615].

UK treaties typically make clear that a UK-resident partner cannot invoke the treaty to avoid UK tax in circumstances akin to *Padmore.* This avoids double non-taxation and is more diplomatic than simply relying on the treaty override mentioned earlier. It is also consistent with the Commentary on the OECD Model as amended in the light of paragraph 128 of the Partnership Report. Furthermore, following the Report on BEPS Action 6, the new Article 1(3) of the OECD Model is a "saving" clause of the type long familiar in treaties with the US[616]. Article 11 of the MLI covers very similar ground and it has been adopted by the UK. This "saving" clause allows each contracting state to continue to tax its residents as if the treaty did not apply, with limited exceptions[617]. Hence, the scope for UK-residents to run *Padmore*-type arguments will increasingly be negated.

6.3 Can a "partnership" or trustee(s) be a "resident" of a Contracting State under a modern UK treaty?

6.3.1 *Article 4(1) of the OECD Model*

While *Padmore* shows that a partnership or trustee(s) can be a "person" for UK tax treaty purposes, that is usually of little benefit unless the "person" is also a "resident" of a treaty state and hence entitled to its protections[618]. The treaty in *Padmore* contained a definition of "resident" which is now archaic. It did not, in particular, require the Jersey partnership to be liable to Jersey tax on the basis that it was formed and established in Jersey.

By contrast, Article 4(1) of the OECD Model now states:

TMA/Section 989 ITA/Section 1119 CTA 2010 definition of "body of persons" should be repealed as otiose and in any case probably does include partnerships, given that "companies" at the start of the nineteenth century were in effect large partnerships (see [1987] BTR 88 at 89-90).

614 There have been unsuccessful challenges to the retrospective legislation, most notably in *Padmore v IRC (No 2)* [2001] STC 280.

615 There remains an argument that *Padmore* potentially exempts the trustees of a non-UK trust which is resident in a treaty jurisdiction, and consequently, exempts the trust income of a UK-resident life interest holder, with a vested interest in that income. That may well be true in theory on the basis that the trustees, like the partners in *Padmore,* are a "body of persons" and hence a "person". *Dawson v IRC* [1989] STC 473 at 475 supports this position but in practice the UK would legislate retrospectively to negate any such outcome.

616 See, for example, Article 1(4) and (5) of the current 2001 UK-US treaty: SI 2002/2848.

617 Notably, the Articles dealing with elimination of double taxation, non-discrimination and the mutual agreement procedure.

618 Of course being a "resident" of a Contracting State is usually a necessary, but not a sufficient condition for treaty protection. That "resident" may also need to show, for example, that it is the "beneficial owner" of the relevant income, and that it does not fall foul of any "Limitation of Benefits" clause.

> "For the purposes of this Convention, the term 'resident of a Contracting State' means any person who, under the laws of that State, is **liable to tax**[619] **therein by reason of his domicile, residence, place of management or any other criterion of a similar nature** [emphasis added], and also includes that State and any political subdivision or local authority thereof as well as a recognised pension fund of that State. **This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein** [emphasis added]."

Wording very similar to this now forms the standard definition of a "resident of a Contracting State" in UK tax treaties. Unless a partnership or group of trustees is taxable as such[620] and that tax liability does not depend on the tax characteristics of its partners/beneficiaries, then it is unlikely to satisfy this definition. In particular, paragraph 40 of the Partnership Report indicates that a partnership is not "liable to tax" for these purposes if any tax payable by it or its partners is determined by the tax characteristics of the partners themselves[621]. The same approach ought to apply to trustees where there is a vested interest in possession in the trust income such that the beneficiary is taxed as if the underlying income arose directly to that beneficiary.[622] In that situation, the question is whether or not the income beneficiary can satisfy Article 4(1).

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[619] In UK tax law, "liable to tax" does not necessarily mean that actual tax is chargeable, not least because a tax exemption may apply in the circumstances e.g. to a pension fund. It simply means that the income in question must potentially be within the relevant tax charge ("within the tax net"). For the distinction between "liable to tax" and "subject to tax" in the treaty context, see the decision of the UK First-Tier Tribunal (Tax) in *Weiser v HMRC* [2012] SFTD 1381. This related to the "Pensions" article in the UK's ageing tax treaty with Israel but the judge also took into account international case law, academic commentary and the OECD Commentary. He endorsed published guidance of the UK tax authorities stating that to be "subject to tax", a person must actually pay tax on the income in question, unless the income in question is low enough to be covered by a "de minimis" exclusion such as the UK "personal allowance". Until 1966, it was standard UK treaty practice to include a "subject to tax" proviso. The thinking in *Weiser* may not be accepted in other jurisdictions: see the 2015 decision of the French Conseil d'Etat in *Ministre du Budget v Landesarztekammer Hessen Versorgungswerk; Ministre du Budget v Societe Santander Pensiones* (joined cases Nos. 370054 and 371132) 18 ITLR 554. The French court ruled that two pension funds were not "liable to tax" (and were therefore not "residents" of Germany and Spain for treaty purposes) because they were exempt from tax/subject to a nil tax rate in those jurisdictions because of their "status or activity". The "Conclusions" of the Rapporteur public, Marie-Astrid de Barmon, suggest (at 569) that the decision partly reflected a French policy of treating non-French tax exempts as "resident" in a treaty state only on a case-by-case basis.

[620] For example, certain limited partnerships are taxed in Australia as companies: see the Commentary in *Resource Capital Fund IV LP v Commissioner of Taxation* (2019) 21 ITLR 655 at 659.

[621] This is so even if, for the purposes of assessment, the income of the partnership is computed at partnership level before being allocated to the partners; and even if the tax on this income is physically paid over by the partnership.

[622] In other words, a trust falling within *Baker v Archer-Shee* [1927] AC 844. In the case of a UK trust, this should be the case even though the trustees can be taxed on the trust income on the basis that they "receive or are entitled to it": this is only a representative charge whose incidence depends on the tax characteristics (and especially the residence) of the beneficiary: see 4.3.3.1 above. However, even if there is a vested interest in possession, certain types of income for tax purposes, but which are not income for trust law purposes, remain taxable at the level of the UK trustees only. This is **not** a representative charge: see 4.3.5. In such cases, one can argue that a trust with a vested income interest is nevertheless a "resident" of a contracting state for treaty purposes.

One commentator has argued that the second sentence of Article 4(1) of the OECD Model means that the "beneficial ownership" condition for treaty relief in some Articles of the OECD Model (first introduced in 1977) is unnecessary where a UK trustee or nominee receives income for a non-UK-resident vested income beneficiary: if that income is non-UK-source, the trustee or nominee will not be liable to UK tax in respect of it, What about an interest in possession trust which falls outside the rule in *Baker v Archer-Shee* because of the trust's governing law? In short, an interest in possession trust with, in particular, UK-resident trustees, where *Garland v Archer-Shee* 15 TC 693 applies. In such cases, the beneficiary's "source" of income is **not** the underlying trust income but, instead, its rights against the trustee(s) to have the trust enforced. In that case, the trustees will be taxable because they "receive or are entitled to" the underlying trust income but this charge is not a purely representative charge whose ultimate incidence depends on the tax characteristics of the beneficiary. The trustee(s) and the beneficiary are in this case being taxed on different sources of income. Hence, the trustee(s) should be regarded as taxable in their own right and as within Article 4(1) of the OECD Model, even though such a case is little different from one within the *Archer-Shee* rule[623]. Trusts subject to *Garland v Archer-Shee* are not discretionary trusts so the non-UK-resident income beneficiary cannot use ESC B18 (see 4.3.5) to get relief for any UK tax borne by the trustees on the underlying trust income. This is harsh, especially as the UK treaty with the beneficiary's home jurisdiction will not give relief for tax paid by the trustees, because it is paid on income which is not from the same "source" as the beneficiary's.

What about a trust which is a discretionary or accumulation trust?[624]. The latter (where trustees can retain trust income and add it to trust capital) are somewhat simpler. If the beneficiaries are not taxed on the retained income as it arises and any tax charged on the trustees in respect of that income is a standalone charge unaffected by the beneficiaries' tax characteristics, then those trustees should fall within Article 4(1) of the OECD Model. If the trust is a pure discretionary trust (which is unlikely[625]), the answer should be the same as for an accumulation trust, if the trustee tax charge is unaffected by the beneficiaries' tax characteristics[626]. This is typically the case in relation to a UK-

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and cannot therefore be "resident" in the UK for treaty purposes, because the charge on the trustee is purely "representative" and will fall away if the income beneficiary is non-UK-resident. That "representative" tax charge will arise if there is UK-source income but in that case, the trustee will be a person who is only liable for UK tax in respect of UK-source income and hence is not a "resident" of the UK because of the second sentence of Article 4(1). See John F. Avery Jones: "The Beneficial Ownership Concept was never necessary in the Model", in "Beneficial Ownership: Recent Trends" ed. Lang, Pistone. Schuch, Staringer and Storck. IBFD publications 2013, Chapter 20 at page 333.

[623] This wafer-thin distinction further illustrates the flaws in *Garland v Archer-Shee* 15 TC 693. There are doubts whether the rule in *Garland v Archer-Shee* can apply where UK-resident trustees receive non-UK-source income for a non-UK-resident vested income beneficiary: see 4.3.3.2.

[624] The beneficial interests in a trust can comprise a vested interest in possession in part of its income while the remaining income is subject to a discretionary and/or accumulation trust.

[625] A pure discretionary trust is one where income of the trust must be distributed in full over a specified period, but the trustees can decide the distribution allocation between beneficiaries. Therefore, a beneficiary may receive nothing. In practice, a discretionary trust is likely to have an accumulation feature.

[626] There is an avoidance risk here because of ESC B18 (see 4.3.5). If UK-resident trustees of a discretionary and accumulation trust claim treaty relief on the basis that they are "resident" in the UK, the UK's treaty partner may lose out if a subsequent trust distribution to a non-UK-resident beneficiary allows the latter to claim relief from any UK tax on the trustees' underlying income on a "look through" basis. For a New Zealand insight into whether trustees can be "resident" for treaty purposes, see John Prebble: "Accumulation Trusts and Double Tax Conventions" [2001] BTR 69. The New Zealand position is complicated by its lack of a separate concept of trust residence. Hence there may be no New Zealand income tax liability in respect of a trust with New Zealand-resident trustees but whose income is not New Zealand-source and whose settlor is not New Zealand-resident. Prebble nevertheless argues that such a trust can claim relief from tax at source under New Zealand's tax treaties. This has been challenged: see Mark Brabazon: "Trust Residence, Grantor Taxation and the Settlor Regime in New Zealand" 22 New Zealand Journal of Taxation Law and Policy (December 2016) at 346 and in particular fn 73 at 360.

resident discretionary trust: see 4.3.5. In particular, there is no deduction at trustee level in respect of any distribution to a discretionary beneficiary. Furthermore, apart from "bare" trusts, all UK-resident trusts are separate taxable entities in respect of chargeable gains, without reference to the beneficiaries' tax characteristics: see 4.3.4 and 4.3.5.

Hence partnerships and some trustees may be unable to claim the benefits of the UK's treaties because they are not "residents" of the other Contracting State. In their Double Taxation Relief Manual[627] HMRC have in the past stated that, where there is no specific treaty provision dealing with partnerships and a partnership is not a "resident" of the other Contracting State for the reasons given above, "the partnership should be treated as transparent for the purpose of claims to relief under a double taxation agreement. Where a partnership is treated as transparent, claims may be made by a partner who is a resident in a country with which the United Kingdom has a double taxation agreement in respect of his share of partnership income as if he had received that income direct." With respect, this statement oversimplifies the situation, although it is presumably inspired by the Partnership Report. It works where both the UK and the treaty jurisdiction where the partner is resident both characterise the "partnership" as "tax transparent" so that the partner is currently taxed in the state of residence on the UK-source partnership income which is eligible for treaty relief. This look-through approach does not, however, work well if the partner's residence state regards the "partnership" as non-"transparent" so that the UK may end up giving treaty relief for UK-source income which is not currently taxed at partner level. In that case, double non-taxation is a real risk. Of course, this is what Article 1(2) of the OECD Model is meant to address more effectively, including the situation where the two contracting states characterise the entity differently: see 6.1.

To date, the UK courts have not been asked to treat a non-UK entity as "resident" for the purposes of a treaty based on Article 4(1) of the OECD Model, on the basis that, although the entity is not liable to tax itself on all of its income in the other jurisdiction, that income is still currently taxable there, either at entity level or in the hands of residents of that jurisdiction with an interest in the entity (e.g. the partners in a partnership). However, non-resident partnership-type entities have been treated as "resident" for treaty purposes on this basis by the Tax Court of Canada in *TD Securities (USA) LLC v Her Majesty the Queen*[628], and also by the Indian Income Tax Appellate Tribunal in *Linklaters LLP v Income Tax Officer – International Taxation Ward 1(1)(2), Mumbai*[629]. In the first case, a US limited liability company sought treaty protection from the Canadian branch profits tax. The Canadian court ruled in its favour, even though it was a single-member "disregarded entity" with no entity-level US tax liability. The claimant won because its sole member was a US corporation whose income was fully liable to current US taxation. The Canadian court was not prepared to treat the limited liability company as "resident" in the US simply because it was formed there[630]. In the second case, the Indian court took a similar line in relation to a UK limited liability partnership which had advised Indian clients. In particular, the court noted that India had not accepted the approach of the Partnership Report[631]. Hence:

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[627] Formerly at DT1750, although no longer available at 24 June 2020.
[628] (2010) 12 ITLR 783.
[629] (2010) 13 ITLR 245.
[630] The case related to taxable periods before the entry into force of a Fifth Protocol to the US-Canada treaty. This was agreed in 2007 and introduced a new Article IV(6) and (7). These are similar to (although more elaborate than) Article 1(2) of the OECD Model: see 12 ITLR 783 at 809. Article 1(2) does not treat a "transparent" entity as itself being "resident" for treaty purposes.
[631] The same is apparently true of Canada: see Angelo Nikolakakis in 12 ITLR 783 at 799.

"…the assessee was indeed eligible to [sic] the benefits of India-UK tax treaty, as long as entire profits of the partnership firm are taxed in UK – whether in the hands of the partnership firm though the taxable income is determined in relation to the personal characteristics of the partners, or in the hands of the partners directly"[632].

This approach of treating the "transparent" entity itself as "resident" for treaty purposes is not consistent with HMRC's position to date, which is more aligned with the Partnership Report and now Article 1(2) of the OECD Model. Article 1(2) may also make the UK courts less receptive to such arguments. Neither court had to address the more difficult situation where the limited liability company/partnership had members resident in more than one jurisdiction and, in particular, not the one in which the entity was formed. It is hard to see how the courts' all-or-nothing approach to entity residence applies in such cases, which are more effectively dealt with, in particular, under Article 1(2) of the OECD Model.

Nevertheless, the approach of the Canadian and Indian courts has some similarities with Article 4 of the former UK-US treaty, which is analysed next.

6.3.2 *Article 4 of the 1975 UK-US treaty*

The UK has experimented in various treaties with other definitions of "resident" which do not depend on a partnership or trust itself being liable to tax. An important example was in the 1975 UK-US treaty.[633] In particular, Article 4(1)(b)(i) of that treaty defined "resident of the United States"[634] as:

"(i) any person, other than a corporation, resident in the United States for the purposes of United States tax; **but in the case of a partnership, estate or trust, only to the extent that the income derived by such partnership, estate or trust is subject to United States tax as the income of a resident, either in its hands or in the hands of its partners or beneficiaries** [emphasis added]; and (ii) a United States corporation."

This definition would permit, for example, a US partnership[635] to be "resident" in the US for treaty purposes (and hence able to claim treaty benefits) if and to the extent that its income was subject to

632 (2010) 13 ITLR 245 at 321. The Mumbai Income Tax Appellate Tribunal has recently followed the *Linklaters* decision in *ING Bewaar Maatschappij I BV – as trustees of ING Emerging Markets Equity Fund v Deputy Commissioner of Income Tax International Taxation Circle 2(2)(1), Mumbai* ITA No. 7119/Mum/2014. In that case, a Dutch "Fonds Vor Gemene Rekening" or FGR could be treated as a resident of the Netherlands for the purposes of the Dutch-India tax treaty. The entity which had been assessed to Indian tax was the Dutch corporate custodian of the FGR. The latter, under Dutch law, was not an entity in its own right but simply a contractual arrangement all whose participants were Dutch-resident taxable entities. The authors of "Some Reflections" op. cit. at pages 326-332 have queried the correctness of these Canadian and Indian decisions.

633 SI 1980/568. This has of course been superseded by the 2001 treaty.

634 Article 4(1)(a) contained a broadly equivalent definition of a "resident of the United Kingdom".

635 There were in fact technical concerns about whether this definition would apply to a US limited liability company which was taxed as a partnership in the US: see Michael McGowan: "Entity Classification under UK Law, with particular reference to the UK-US double tax treaty"- November 1994 paper presented to the Princeton Tax Club in New York, pages 40-44. In practice, the UK tax authorities appeared to ignore these concerns and to assimilate such a limited liability company to a partnership for the purposes of applying Article 4(1)(b). This practice was first published in the June 1997 edition of "Tax Bulletin". It was repeated on page 3 of the April 2003 special edition of "Tax Bulletin", commenting on the 2001 UK-US treaty (at 6.4).

US tax either at entity level (which would be unusual) or in the hands of US-resident partners. This meant that a US partnership with some non-US-resident partners would only be regarded as "semi-resident" in the US for treaty purposes. Therefore, the definition addressed the problem of members' mixed residence which was not addressed by the Canadian and Indian court decisions mentioned in 6.3.1.

This provision was unique in UK treaties and has not been replicated in the 2001 treaty which is discussed in 6.4[636]. Article 4(1)(b)(i) was **not** simply a "look through" rule. If it applied to a partnership, estate or trust, then that entity itself (and not its members/beneficiaries) was the "person" "resident in the United States" which could claim treaty benefits. That could affect what treaty benefits were available when compared to the position if the entity was simply "looked through". For example, suppose that a US partnership was owned 50:50 by two US corporations, A and B, and that the partnership itself owned all of a UK-resident company, C. Therefore, A and B each had indirect economic ownership of 50% of C via the partnership. However, the effect of Article 4(1(b)(i) was that the partnership itself was not "looked through" but was treated as itself being a resident of the United States, because all its partners were taxpaying US corporations. Being a resident of the United States, the partnership was therefore entitled to a partial refund[637] of the UK imputation "tax credit"[638] which attached to any dividend paid by C to the partnership. However, although treated as a resident of the United States, the US partnership remained a partnership, not a corporation under the 1975 treaty. Hence it could not claim the larger refund of the imputation "tax credit" which was only available for dividends **paid to US corporations** controlling a significant shareholding in a UK-resident company[639]. Furthermore, because (i) Article 4(1)(b)(i) did not "look through" the US partnership to its corporate partners, A and B, and (ii) that US partnership would typically have legal personality, there was no clear scope for either partner to claim its share of that larger refund even though each effectively owned 50% of C via the partnership.

Matters would have been different if A and B had simply formed a contractual joint venture (falling short of partnership) to co-own C 50:50 directly. They might also have been different if the "Residence" Article of the 1975 UK-US treaty had mandated a "look through" approach instead, and depending on the extent of the "look through".

For a partnership to be a "resident of the United States" under Article 4(1)(b)(i), it was, strictly, not enough for all its partners to be US-resident taxpayers. In particular, the opening words of the paragraph could be read as requiring the partnership itself to be "resident in the United States for the

[636] The Partnership Report was unenthusiastic (see paragraphs 45-6) about "residence" definitions such as Article 4(1)(b). A particular concern was that they enabled third-country partners to obtain treaty benefits by having a "permanent establishment" in the state of the partnership. The words "as the income of a resident" in Article 4(1)(b)(i) resolve this concern. Other US double tax treaties, such as the US treaty with Norway dated December 3 1971, contained language similar to Article 4(1)(b): see "Tax Treaties, Partnerships and Partners: Exploration of a Relationship" – Richard O. Loengard, Jr (1975) 29 Tax Lawyer 31 at 37 (hereafter "**Loengard**"). Article 4(1)(b) of the US Model Income Tax Treaty of 1981 also contained language similar to Article 4(1)(b), but such language no longer features in the US Model. There is further discussion of such "partial residence" articles in "Some Reflections" op. cit. at 326-332.
[637] Under Article 10(2)(a)(ii) of the 1975 treaty. It is assumed that for these purposes, the US partnership would be the "beneficial owner" of the dividends from C and that the anti-avoidance rules in Article 10(7) did not apply.
[638] Formerly available under Section 231 Income and Corporation Taxes Act 1988 and now abolished.
[639] See Article 10(2)(a)(i) of the 1975 treaty.

purposes of United States tax"[640]. Hence a partnership in a third state all of whose partners were US-residents would apparently not fall within Article 4(1)(b), further illustrating its non-"look through" nature.

This particular concern has been considered by the Australian courts recently. While Article 4(1) has not been litigated in either the UK or the USA, the Australian Federal Court (Full Court) considered a very similar definition of a "resident of the United States" in Article 4(1)(b)(iii) of the US-Australia treaty, in *Resource Capital Fund IV LP v Commissioner of Taxation.*[641] That case related to gains on the sale of shares in a Toronto-listed, Australian lithium mining company. The sellers were Cayman Island limited partnerships, many of whose partners were apparently US-resident for tax purposes. It was accepted that these partnerships were "transparent" for US tax purposes, but were taxable entities in their own right in Australia. The majority of the court read the relevant definition of "resident of the United States" quite restrictively[642]. Firstly, the court ruled (rather harshly) that there was no evidence that the income of the partnerships was in fact subject to US tax. In any case, Article 4(1)(b)(iii) required the partnership to meet two conditions: it had to be a resident of the United States itself for tax purposes and its income had to be subject to US tax. A partnership formed in the Cayman Islands could not be a resident of the United States for US tax purposes and so the first condition was not met. Hence neither partnership could rely on Article 4(1)(b)(iii) to show that it was treaty-resident[643]. The majority went on to indicate that each US-resident partner in either partnership could in fact rely on the treaty but not in these proceedings which involved a tax assessment on the limited partnership itself[644].

The majority interpretation is both restrictive and impractical, not least because of the procedural restrictions it imposes on each partner when claiming treaty benefits. An alternative, and superior,

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[640] For further discussion about the problems this raised, see the paper mentioned in fn 635 and in particular at pages 41-3, where it is noted that under US tax law, the concept of the "residence of a partnership" has little independent significance. Furthermore, to the extent this concept is defined (e.g. in the regulations under Section 861 Internal Revenue Code defining US-source income), using this definition when interpreting Article 4(1)(b)(i) could lead to anomalies, with some US-formed investment partnerships being unable to claim that they were US-resident, because they lacked a US trade or business! For more recent comments to the same effect, see Blanchard: "The Tax Significance of Legal Personality: a US View", op. cit. at page 47.

[641] (2019) 12 ITLR 655.

[642] (2019) 12 ITLR 655 at 695-699.

[643] In this respect, the majority of the court followed the first instance judge in *Resource Capital Fund III LP v Commissioner of Taxation* (2013) 15 ITLR 814 ("*RCF III*"). They noted that their conclusion that the Cayman limited partnership could be assessed as a taxable entity, despite the US-Australia treaty, was consistent with the decision of the Full Federal Court when *RCF III* was appealed: see *Commissioner of Taxation v Resource Capital Fund III LP* (2014) 16 ITLR 876. For further discussion of *RCF III,* see John Azzi: "Impact of the OECD Multilateral Convention to implement tax treaty related measures to prevent base erosion and profit shifting on the taxation of fiscally-transparent entities under the Australia-UK double tax agreement": [2018] BTR 556. That article predates the decision of the Full Federal Court in *RCF IV.* That commentator notes that the High Court of Australia refused special leave to appeal against the Full Federal Court's decision in *RCF III,* and questioned whether individual partners could contest the Australian tax assessment on the limited partnership. It was even suggested that the only way they could do so was via the treaty-based mutual agreement procedure. That commentator rightly questions how effective such a remedy would be, even now that the MLI has introduced a binding arbitration mechanism into the UK-Australia treaty. There is further discussion of the UK-Australia treaty at 6.8.1.

[644] The court indicated that a partner could invoke the treaty in recovery proceedings or in seeking a declaration that the treaty protected that partner's profit share. The court did not allude to the possibility of using the mutual agreement procedure: see fn 643.

interpretation was put forward in Davies J's partial dissent in the same case[645]. The judge rejected the two condition approach and, in particular, the idea that Article 4(1)(b)(iii) required the partnership itself to be a resident of the United States for tax purposes. Rather:

> "…..although under United States tax law a partnership is a fiscally transparent entity, the proviso in Article 4(1)(b)(iii) would attribute a residency status to a partnership separate from its partners for the purposes of the application of the [treaty] where income of the partnership is taxable in the hands of the United States partners (or if exempt from United States tax, it is exempt other than because such partners are not United States residents). On this construction, it is the residency of the United States partners for United States tax law purposes which would dictate whether a partnership is a resident of the United States for the purposes of the [treaty]. On this construction also, there is no separate and additional requirement that partnerships be recognised by the United States as a resident of the United States. **Rather, partners who are United States residents and taxable in the United States on the partnership income may claim through the partnership to get the benefit of the [treaty] whether or not the partnership is a United States domestic partnership** [emphasis added]".

Again this alternative interpretation does not have the same "look through" effect as Article 1(2) of the OECD Model because it recognises that Article 4(1)(b)(iii) confers residence for treaty purposes on the partnership entity itself, to the extent that its income is subject to tax in the hands of its US-resident partners. However, it gives treaty relief to partnerships formed outside the US to the extent that their partners are US-residents. This is sensible: partnerships are "transparent" anyway for US income tax purposes so little purpose is served by reading the treaty restrictively so as to require the partnership itself to be formed in the US.

Article 4(1)(b) of the 1975 treaty also applied to trusts and estates. The US Technical Explanation of that treaty stated that, consequently, "the treatment of income received by a trust or estate will be determined by the residence and taxation of the person subject to tax on such income, which may be the grantor [i.e. the settlor], the beneficiaries or the trust or estate itself, as the case may be"[646]. While the US Technical Explanation is a purely unilateral commentary by one state on the treaty, and therefore of limited persuasive authority before a UK court, this statement seems sensible. In particular, it caters for the different ways in which the income of a trust may be taxable in the hands of US persons, whether at trust level or in the hands of others linked to the trust. As with partnerships, the US Technical Explanation makes no mention of Article 4(1)(b)(i) requiring the trust or estate to be a resident of the US in its own right for US tax purposes.

A final weakness of Article 4(1)(b) of the 1975 UK-US treaty was that it did not cater easily for situations where the two contracting states had different ideas of what amounted to a "partnership, estate or trust". As one commentator has put it:

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[645] (2019) 12 ITLR 655 at 758-763. Davies J's interpretation is in fact consistent with the interpretation of Article 4(1)(b)(i) of the 1975 UK-US treaty in the US Treasury's Technical Explanation of that treaty:

https://www.irs.gov/pub/irs-trty/uktech.pdf (accessed 24 June 2020).

[646] https://www.irs.gov/pub/irs-trty/uktech.pdf (accessed 24 June 2020).

"Thus there would seem to be a sound practical reason for looking to the partner's residence to determine the application of tax to a partnership's income. **A rule which looks solely to the partners and disregards the partnership entirely not only prevents abuse of the treaty but also avoids attaching undue significance to determining whether a partnership exists.** [Emphasis added] This latter point is especially significant in connection with US tax because the United States treats a loosely organised joint venture (sometimes amounting to little more than co-ownership of property) as a partnership….if the joint activity rises above the level of mere investment. This being so, it seems highly desirable that the international significance of the existence of a partnership be minimized".[647]

Consequently the 2001 UK-US treaty has taken a rather different approach to these issues, in line with later changes to the US Model tax treaty. Article 1(2) of the OECD Model has now gone down the same road.

6.4 The approach of the 2001 UK-US tax treaty to "tax transparent" entities

6.4.1 *Introduction*

The treatment of "tax transparent" entities was a key issue when the UK last renegotiated its tax treaty with the US[648]. The 2001 UK-US treaty[649] takes a very different approach to the 1975 treaty and in so doing, both echoes the Partnership Report and anticipates Article 1(2) of the OECD Model and Article 3 of the MLI. Article 1(1) provides that:

"Except as specifically provided herein, this Convention is applicable only to persons who are residents of one or both of the Contracting States".

Article 3(1)(a) and (b) then provide that "unless the context otherwise requires",

"(a) the term 'person' includes an individual**, an estate, a trust, a partnership** [emphasis added] a company and any other body of persons; (b) the term 'company' means any body corporate or any entity that is treated as a body corporate for tax purposes."

Hence the treaty makes very clear that trusts and partnerships are "persons". It is standard US treaty practice to be so explicit[650]. Article 4(1) then sets out a definition of "resident of a Contracting State" which is very different from Article 4(1)(b) of the 1975 treaty:

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[647] See Loengard op cit. at page 43. This comment foreshadows Article 1(2) of the OECD Model and Article 3 of the MLI. The problem highlighted by this comment had an impact on whether a US limited liability company treated as a partnership for US tax purposes could claim the benefit of the 1975 UK-US treaty because the UK does not regard such entities as partnerships for UK tax law purposes: see also pages 34-40 of the paper mentioned in fn 635. As noted there, UK published practice has tended to gloss over this issue. For further discussion of the US entity classification rules, see 7.2.
[648] Not least because of the radical changes in 1997 (see 7.2) to the US entity classification tax rules and the introduction of UK limited liability partnerships in 2000.
[649] SI 2002/2848.
[650] For a slightly different approach, which sees a trust as a quasi-person, see the definition of "entity" as a "legal person or a legal arrangement such as a trust" in Article 1(hh) of the September 2012 Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the United States of America to improve international tax compliance and to implement FATCA".

> "….the term 'resident of a Contracting State' means, for the purposes of this Convention, any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature…."

This is very similar to Article 4(1) of the OECD Model and means, in particular, that a partnership whose income is taxable only at partner level, by reference to the personal characteristics of the partners, is not a "resident of a Contracting State" for the purposes of the 2001 treaty. But this is not the end of the story[651].

6.4.2 *Article 1(8) and Article 1(4)*

In particular, Article 1(8) of the 2001 treaty[652] also provides:

> "An item of income, profit or gain derived through a person that is **fiscally transparent under the laws of either Contracting State** [emphasis added] shall be considered to be derived by a resident of a Contracting State to the extent that the item is treated for the purposes of the taxation law of such Contracting State as the income, profit or gain of a resident".

In other words, this rule operates (to some degree) as a "look through" rule, conferring treaty benefits on the resident of a treaty state who derives and is liable to tax as a resident on the income in question, so long as that income is derived via a person regarded as "fiscally transparent" in the state in which that person is resident, or in the other contracting state. Article 1(8) therefore differs from Article 4(1) of the 1975 treaty. It does not seek to make the "fiscally transparent" person itself a resident of either the UK or the US[653]. Indeed, it appears to apply even where the "fiscally transparent" person is established in a state other than the UK or the US[654]. The entire focus is on the tax treatment of those deriving income via that person. Crucially, Article 1(8) can operate even if only one of the treaty partners regards the person as "fiscally transparent". It is not necessary that the UK and the US see eye to eye on the classification of the relevant entity. This sidesteps a key weakness of Article 4(1)(b) of the 1975 treaty. Unlike Article 1(2) of the OECD Model, Article 1(8) does not expressly cover cases of "partial transparency".

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[651] One assumes that the UK courts would be unlikely to interpret Article 4(1) in the same way as the Canadian and Indian courts in the cases mentioned in, respectively, fns 628 and 629. In particular, Article 1(8) indicates an alternative approach to dealing with "transparent" entities for treaty purposes.
[652] Article 1(8) is based on the US domestic withholding tax regulations under Section 894(c) Internal Revenue Code 1986 and the 1996 US Model double tax treaty: see Avery Jones: Partnerships op. cit. at pages 430-1. For a discussion of the equivalent, and slightly different provision in the 2006 and 2016 versions of the US Model treaty, see "Some Reflections" op. cit. at pages 309-311.
[653] In the HMRC Double Taxation Relief Manual at DT19853 (accessed 24 June 2020), there is a statement that Article 1(8), like the 1975 treaty, treats partnerships "as residents of a particular country only to the extent that their income is taxed in that country as income of a resident". This does not seem correct and is at odds with the first paragraph of DT19851A (accessed 24 June 2020).
[654] This is what the treaty says and is the view expressed in the US Treasury Technical Explanation of the 2001 treaty https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf (accessed 24 June 2020). That document is of course purely the view of one Contracting State and hence has minimal weight as a tool of interpretation in a UK court, unlike the Exchange of Notes discussed below.

Article 1(8) operates in tandem with the "saving" clause which has long been a feature of all modern US tax treaties[655]. In this case, it is in Article 1(4) which reads:

> "Notwithstanding any provision of this Convention except paragraph 5 of this Article, a Contracting State may tax its residents (as determined under Article 4, (Residence)), and by reason of citizenship may tax its citizens, as if this Convention had not come into effect".

Article 1(5)(a) provides, however, that Article 1(4) does not prevent a resident of a Contracting State from invoking "the benefits conferred…….under paragraph 2 of Article 9 (Associated Enterprises), sub-paragraph (b) of paragraph 1 and paragraphs 3 and 5 of Article 17 (Pensions, Social Security, Annuities, Alimony and Child Support), paragraphs 1 and 5 of Article 18 (Pension Schemes) **and Articles 24 (Relief from Double Taxation), 25 (Non-discrimination), and 26 (Mutual Agreement Procedure) of this Convention** [emphasis added]".

The interplay between Article 1(8) and the "saving" clause, as well as other aspects of Article 1(8), are set out more fully in the Exchange of Notes signed by the UK and the US in conjunction with the 2001 treaty. In particular, the Exchange of Notes states:

> "It is understood that where an item of income, profit or gain is derived through a person which is a resident of a Contracting State the provisions of [Article 1(8)] shall not prevent that Contracting State from taxing the item as the income, profit or gain of that person[656].
>
> It is further understood that, where, by virtue of [Article 1(8)], an item of income, profit or gain is considered by a Contracting State to be derived by a person who is a resident of that Contracting State and the same item is considered by the other Contracting State to be derived by that person or by a person who is a resident of that other Contracting State, [Article 1(8)] shall not prevent either Contracting State from taxing the item as the income, profit or gain of the person considered by that State to have derived the item of income, profit or gain[657].
>
> It is further understood that, in applying [Article 1(8)], the United Kingdom shall, exceptionally, regard an item of income, profit or gain arising to a person as falling within [Article 1(8)] where another person is charged to United Kingdom tax in respect of that item of income, profit or gain:
>
> (a) under section 660A or 739 Income and Corporation Taxes Act 1988[658]; or

[655] And which is now included in Article 1(3) of the OECD Model and Article 11 of the MLI.
[656] If all else fails, by relying on Article 1(4).
[657] This is consistent with Article 1(8) not being listed in the exceptions to the "saving" clause in Article 1(5). Consequently Article 1(8), as interpreted in the Exchange of Notes, creates a significant risk of double taxation because of conflicting characterisations by the UK and the US e.g if one states taxes the fiscally transparent entity as a resident and the other state taxes its members on the entity's underlying income. A good example would be where income is earned by a UK-resident unlimited liability company whose sole shareholder is a US corporation. This risk is intended to be mitigated via Article 24 (Relief from Double Taxation) as expanded by the Exchange of Notes: see 6.4.3.
[658] Section 660A has been repealed and replaced by the essentially similar Sections 624-628C in Part 5 Chapter 5 ITTOIA which impose income tax on the "settlor" of certain arrangements amounting to "settlements", where the "settlor" retains an interest in the "settlement". Part 5 Chapter 5 contains other rules which also attribute income of a "settlement" to the "settlor", notably under Section 629 ITTOIA, where income is paid to relevant children of the settlor. These other rules were in existence in 2001 but are not listed in the Exchange of Notes,

(b) under section 77[659] or 86 Taxation of Chargeable Gains Act 1992.

It is further understood that, in applying [Article 1(8)], a person shall be regarded as fiscally transparent under the laws of the United Kingdom in relation to an item of income, profit or gain where a charge is made on another person on that item either:

(a) by virtue of section 13 Taxation of Chargeable Gains Act 1992[660]; or
(b) because that other person has (or under section 118 Finance Act 1993, is treated as having) an equitable right in possession in a trust"[661].

The latter paragraphs of this section of the Exchange of Notes are an attempt by the UK in particular to clarify, and indeed expand, what is meant by "fiscal transparency" for Article 1(8) purposes. "Fiscal transparency" is otherwise undefined and this clarification is only partial. Interestingly, Article 1(8) is clearly regarded by the UK as applying where income or gain of a person is imputed to a UK-resident under various anti-avoidance or anti-deferral rules, even though these rules would not ordinarily be seen as making that person "fiscally transparent"[662]. The anti-deferral rules listed are not an exhaustive list of such rules. In particular, they do not include the UK "controlled foreign company" rules, for reasons which are unclear[663]. However, the overall approach is sensible: if income or gain of an entity is effectively liable to current UK taxation in the hands of a person with an interest in that

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for reasons which are unclear. Part 5 Chapter 5 is one limb of the UK equivalent of the US grantor trust rules. Section 739 has been repealed and replaced by the essentially similar "Transfer of Assets Abroad" rules in Part 13 Chapter 2 ITA In particular, Section 739 is replaced by the income tax charge in Sections 720-1 ITA on a UK-resident individual with "power to enjoy" income arising from certain transfers of assets outside the UK.

[659] Section 77 was repealed in 2008. It treated a UK-resident settlor of a UK-resident trust as taxable on capital gains of that trust. It became redundant when UK-resident trusts became taxable on their capital gains at the highest marginal UK rate. Section 86 is the equivalent rule taxing a UK-resident settlor of a non-UK-resident trust in respect of capital gains of that trust.

[660] Section 13 TCGA has been replaced by Sections 3-3G TCGA, although the substance remains essentially the same. The effect is usually to attribute the actual capital gains of a non-UK-resident, closely-held company to its UK-resident shareholders and certain other UK-residents ("participators") with a direct or indirect interest in it.

[661] This refers to the rule in *Baker v Archer-Shee*: see 4.3.3. Section 118 Finance Act 1993 (now Section 464 ITA) applies that rule to trusts formed under the law of Scotland, even though Scottish law does not distinguish between legal and equitable interests in property. For further discussion of the Scottish position, see 4.3.3.2.

[662] In the US Treasury Technical Explanation of the 2001 treaty op.cit., it is stated that for US purposes, "fiscally transparent" persons will include partnerships, common investment trusts under section 584 Internal Revenue Code, grantor trusts and US limited liability companies which are treated as partnerships for US tax purposes.

[663] The UK "controlled foreign company" rules are now in Part 9A TIOPA. They may not be mentioned in the Exchange of Notes because they do not technically impose a charge directly on the underlying income of the company in question: see fn 8. However, this explanation is not convincing because the same is true, for example, of the "Transfer of Assets Abroad" rules mentioned in fn 658, which (as the successor of Section 739 Income and Corporation Taxes Act 1988) are presumably meant to be covered by the Exchange of Notes. In *IRC v Willoughby* [1995] STC 143 at 169, the UK Special Commissioner of Income Tax ruled that Section 739 in its original form was a charge on deemed income measured by reference to another (non-UK) person's actual income. Hence Section 739 could not be overridden simply because the non-UK owner of the actual income was treaty-protected. The taxpayer in *Willoughby* succeeded on other grounds, including in the House of Lords: see [1997] STC 995. The higher courts did not consider the treaty argument. For further discussion of *Willoughby,* see Daniel Sandler: "Tax Treaties and Controlled Foreign Company Legislation – Pushing the Boundaries" (2nd edition - 1998) Kluwer Law International at pages 194-5. The approach in *Willoughby* has been followed recently by the Upper Tribunal (Tax and Chancery Chamber) in *Davies, McAteer and Evan-Jones v HMRC* [2020] UKUT 67 (TCC). That case related to the interaction between the UK-Mauritius tax treaty and both Section 739 and its successor, the "Transfer of Assets Abroad" rules.

entity, then the policy underlying Article 1(8) is being met. This is so even if that entity (e.g. a non-UK-resident closely-held company) would not be regarded, classically, as "transparent" in the same way as, say, a partnership.

One commentator[664] has suggested that Article 1(8) (or Article 1(2) of the OECD Model) may not give treaty relief at source to a UK-resident if rules of the kind discussed in the previous paragraph do not attribute the **actual** income or gain of a person to a UK-resident but only a **notional amount** computed by reference to that income or gain[665]. The author is unpersuaded. The UK attribution rules referred to in the Exchange of Notes often, although not always, attribute a notional amount to a UK-resident yet this is not a bar to applying Article 1(8) of the UK-US treaty. This is a sensible result. The UK has often drafted its attribution rules in this way, so that they apply even if the underlying income or gain used to determine the notional amount is the actual income of a treaty-protected non-UK-resident. Hence drafting attribution rules in this way is intended to defeat *Padmore*-type arguments (see 6.2.2) by **UK-residents**. It is not clear why a drafting technique to prevent tax avoidance in the **residence** state of a taxpayer with an interest in a "transparent" entity should then lead to treaty relief being denied in the **source** state under a provision such as Article 1(8). For the source state, what matters is that an amount corresponding to source state income derived by or through that entity is, at a minimum, liable to current taxation in the hands of a resident of the treaty partner. If that current taxation occurs by attribution under, say, a "controlled foreign company" rule, it is the rule's effect that matters, not its precise linguistic structure. In any case, if its linguistic structure better ensures current taxation in the non-source state, that protects the interests of the source state too. The author's preferred interpretation is also consistent with the anti-hybrid mismatch rules in the first part of the October 2015 OECD Recommendations on BEPS Action 2. Recommendation 5.1 (at paragraph 171) states that "payments made through a reverse hybrid structure will not result in a [deduction/non-inclusion mismatch] if the income is fully taxed under a CFC, foreign investment fund (FIF) or a similar anti-deferral rule in the investor jurisdiction that requires the investor to include its allocated share of any payment of ordinary income made to the [entity] on a current basis."

Article 1(8) will give effect to one state's analysis of an entity as "fiscally transparent" but only if this leads to residents of that same state being liable to current taxation on the entity's underlying income. Therefore, when giving treaty relief on that income, the source state can be confident that double non-taxation should not arise, unless there are separate policy-based reasons for non-taxation of those with an interest in the entity (e.g. entity members which are recognised tax-exempts). Because of its right to tax its own residents (in Article 1(4)), the source state can also be confident that the treaty will not restrict its taxing powers in a purely "domestic" situation i.e. where source state income flows to an entity resident in the source state. The source state can tax that entity as a resident even if it is regarded as "transparent" in the other contracting state.

6.4.3. *Article 24 and the Exchange of Notes*

The way Article 1(8), together with Article 1(4), is interpreted in the Exchange of Notes creates a particular risk of double taxation if one state taxes an entity as a resident taxpayer under its own domestic laws while the other state regards that entity as "fiscally transparent" and therefore taxes the entity's members resident in that other state on their share of the entity's underlying income as it

[664] See Brabazon op. cit. at pages 226-229.
[665] See fns 660 and 663 for examples of rules structured in each of these ways.

arises. For example, consider *Bayfine UK v HMRC*[666]. *Bayfine* involved a tax avoidance scheme based on the "saving" clause (Article 1(3)) in the 1975 UK-US treaty coupled with the elimination of double taxation article in that treaty (Article 23). A key aspect of the structure was that a US corporation wholly owned a UK unlimited company. The latter made a profit from entering into a derivative contract. The UK taxed the profit of what it perceived to be a UK-resident company (either under the "Business Profits" Article of the treaty or by relying on the "saving" clause). However, the US treated the unlimited company as "fiscally transparent" in the most absolute sense: it "disregarded" it under US domestic tax rules because it was unlimited and had only one member[667]. The US therefore treated the income of the unlimited company as belonging to its US parent and sought to tax it accordingly under the "saving" clause. Hence each jurisdiction was seeking to tax the same pool of profit in a situation which would now fall under Article 1(4) and 1(8) of the 2001 treaty. The UK courts ultimately refused the unlimited company a foreign tax credit for the US tax incurred by its US parent. The Exchange of Notes to the 2001 treaty seeks to address this important economic double taxation risk, to a degree which is not encountered in other UK tax treaties, or indeed in double tax treaties generally[668]. In particular, it states the following in relation to Article 24 (Relief from double taxation):

> "It is understood that, under paragraph 4 or 8 of Article 1….., the provisions of the Convention may permit the Contracting State of which a person is a resident (or, in the case of the United States, a citizen), to tax an item of income, profit or gain derived through another person (the entity) which is fiscally transparent under the laws of either Contracting State, and may permit the other Contracting State to tax (a) the same person; (b) the entity; or (c) a third person with respect to that item.
>
> Under such circumstances, **the tax paid or accrued by the entity shall be treated as if it were paid or accrued by the first-mentioned person for the purposes of determining the relief from double taxation to be allowed by the State of which that first-mentioned person is a resident (or, in the case of the United States, a citizen), except that, in the case of an item of income from real property to which paragraph 1 of Article 6 …..of the Convention applies, or a gain from the alienation of real property to which paragraph 1 of Article 13 …..applies, the tax paid or accrued by the person who is a resident of the Contracting State in which the real property is situated shall be treated as if it were paid or accrued by the person who is a resident of the other Contracting State**. [emphasis added]
>
> In the case where the same item of income, profit or gain derived through a trust is treated by each Contracting State as derived by different persons resident in either State, and (a) the person taxed by one State is the settlor or grantor of a trust; and (b) the person taxed by the other State is a beneficiary of that trust, the tax paid or accrued by the beneficiary shall be treated as if it were paid or accrued by the settlor or grantor for the purposes of determining the relief from double

[666] [2011] STC 717 reversing [2010] STC 1379 and upholding [2009] STC (SCD) 43.
[667] See 7.2.5 for further discussion of the relevant US tax rules.
[668] Article 3(2) of the MLI makes clear that a residence state is not expected to give double taxation relief for tax imposed on the same income by the other contracting state **solely** on the basis of residence. The UK has reserved against this part of the MLI but for linguistic reasons only. As *Bayfine* (supra) illustrates, the UK agrees with the underlying policy. For a fuller discussion of the limited extent to which tax treaties address double taxation where two states each tax on the basis of residence alone, see Brabazon op. cit. at pages 246-250, in which it is rightly pointed out that such situations are especially likely to arise in respect of trusts where a contracting state may seek to tax any of the following persons as a resident taxpayer: the trust itself, a beneficiary or the grantor/settlor.

taxation to be allowed by the State of which that settlor or grantor is a resident (or, in the case of the United States, a citizen), except that, in the case of an item of income from real property to which paragraph 1 of Article 6 …..of the Convention applies, or a gain from the alienation of real property to which paragraph 1 of Article 13 ….applies, the tax paid or accrued by the person who is a resident of the Contracting State in which the real property is situated shall be treated as if it were paid or accrued by the person who is a resident of the other Contracting State.

It is further understood that paragraphs 2 and 5 of Article 24 shall apply to such an item of income, profit or gain to the extent necessary to provide relief from double taxation[669]."

The highlighted words apply directly to the *Bayfine* situation. In particular, the UK tax payable by the UK unlimited company is to be treated as "paid or accrued" by the US company[670] when determining what double taxation relief the latter can claim in respect of the income on which it is taxed under the "saving" clause when the US "disregards" the UK subsidiary.

This wording in the Exchange of Notes was briefly considered by the Court of Appeal in *Anson v HMRC*[671], where the taxpayer sought to rely on it at quite a late stage in respect of that part of its UK foreign tax credit claim which fell within the 2001 treaty[672]. *Anson* was discussed in detail in 2.14. The attraction to the taxpayer of relying on the Exchange of Notes was that, if it applied, a UK foreign tax credit was available for the taxpayer's share of the US Federal and state income taxes on the income of the limited liability company ("LLC"), whether or not that income belonged to the taxpayer as it arose. Put another way, it was no longer necessary to show, for UK foreign tax credit purposes, that UK and US tax had been paid on **the same** profits. The Court of Appeal declined to allow this point to be introduced at a fairly late stage. Arden LJ (as she then was) stated, at paragraph 92:

[669] This sentence refers to the rules in Article 24 which define the "source" of items taxable according to the allocation rules in the 2001 treaty. Those "source" rules make it easier to claim double taxation relief, usually by treating an item taxable in a contracting state in accordance with the treaty as having a "source" in that state for the purposes of granting double taxation relief in the other state.

[670] The US company would **not** be entitled to double taxation relief for any withholding tax payable on a distribution to it by its "disregarded" UK subsidiary. It can only claim a credit for what would otherwise be underlying tax on the profits of the UK subsidiary. This distinction is odd. The overall goal seems to be that a resident ("A") of the jurisdiction which perceives the entity to be "transparent" should not suffer double taxation simply because the other jurisdiction perceives the entity differently, provided that A is currently taxed in its state of residence on its share of the income of that entity. In that case, logic would suggest that any taxation on the entity's profits (distributed or undistributed) should generate double taxation relief in A's jurisdiction of residence, where those profits are being fully taxed. While this distinction between tax on distributed and undistributed profits of the entity is odd, paragraph 133 of the Partnership Report draws the same distinction in its Example 18. That Report argues that because the residence state of A sees the entity as "transparent" and therefore does not tax a distribution from the entity, it should not be required to give double taxation relief for any withholding tax on that distribution. It should only be required to give such relief for underlying tax on the entity. The author finds this distinction unconvincing (as clearly do the authors of "Some Reflections" op. cit.). For practical budgetary reasons, A's right to claim relief for withholding on a distribution would need to be limited to distributions paid within a set time period. The Netherlands-Belgium treaty of 2001 apparently does not draw the same distinction as the Partnership Report. It does give relief from possible double taxation when there is a distribution by an entity treated as "transparent" in the state where its members are resident. It does this by having the residence state of that entity waive its tax on such a distribution: see Verhoog & Breuer: "Hybrid Entity Issues in a Tax Treaty Context: OECD Approach versus Actual Tax Treaties" Volume 44 Intertax Issue 8 and 9, 684 at 694.

[671] [2013] STC 557 and in particular paragraphs 87 to 93.

[672] Most of the relevant tax years fell under the 1975 treaty to which the Exchange of Notes does not apply.

> "There is clearly some dispute as to the mischief to which the exchange of notes is directed. There would have to be further evidence to resolve that dispute. Moreover, the words 'with respect to that item' [at the end of the first paragraph of the part of the Exchange of Notes dealing with Article 24] ….are, on the face of it, consistent with [HMRC's submission] that no change is made in the requirement for the profits taxed in each jurisdiction to be the same profits in order to qualify for [double taxation relief]. If an alteration to Article 23 [sic] was intended, it is surprising that it was dealt with in this oblique way."

The author considers that Arden LJ ignored a large part of the point that the Exchange of Notes is making. Because of the way Article 1(8) and the "saving" clause interact, there is scope for different persons to be taxed in respect of the same profits (as in *Bayfine*), not least because of differences between UK and US domestic tax rules on entity classification. The effect of those rules may well be that one jurisdiction perceives the profits to be the income of one legal person while the other jurisdiction regards them as the profits of a second person, because that other jurisdiction treats the first legal person as "tax transparent". Left unaddressed, there could therefore be unrelieved double taxation[673]. The part of the Exchange of Notes dealing with Article 24 seeks to address this. It cannot address this problem effectively[674] if "no change is made in the requirement for the profits taxed in each jurisdiction to be the same profits in order to qualify for [UK double taxation relief]".

However, on a narrower point, the Court of Appeal was correct to reject the taxpayer's submission. The relevant part of the Exchange of Notes only addresses a situation where the person claiming double taxation relief is resident in a treaty jurisdiction which regards the relevant entity as "transparent" while the other jurisdiction regards it as "opaque" and hence taxable in its own right. Those facts are the converse of *Anson* where Mr Anson was a resident of the UK which sought to treat the LLC as "opaque", while the US regarded it as "tax transparent" so that its income was only taxable for US purposes at the level of its members. The Exchange of Notes would have been relevant if Mr Anson had invested in a US partnership (usually recognised as "tax transparent" in the UK) which had elected to be taxed as a corporation in the US[675]. The fact that the Exchange of Notes does not cover

[673] The UK will give a unilateral foreign tax credit for non-UK tax imposed on income or gain of a UK taxpayer, even if that non-UK tax is imposed on a different person. In each case, the UK and non-UK tax must be calculated by reference to the same income or gain, and the income must arise or the gain accrue in the jurisdiction imposing the non-UK tax. Hence, identity of taxable income or gain is required and the tax must be imposed by the jurisdiction of source, not just on the basis of residence. Identity of taxable persons is not required: see Section 9 TIOPA.

[674] The Exchange of Notes should have the same force in UK domestic law as the main body of the treaty. In particular, the concept of "arrangements" in the treaty-enabling legislation in Section 2 TIOPA should be wide enough to include a contemporaneous Exchange of Notes signed by both contracting states and appended to the treaty itself. For a useful recent summary of the broader, more purposive approach of the UK courts to interpreting tax treaties, as well as the materials they will take into account, see the judgment of the Upper Tribunal (Tax and Chancery Chamber) in *Irish Bank Resolution Corporation Limited (in special liquidation), Irish Nationwide Building Society v HMRC* [2019] UKUT 277 (TC), especially paragraphs 22-26.

[675] This in effect is the mirror image of the first example set out on page 95 of the US Treasury Technical Explanation of the 2001 treaty op.cit., towards the start of the discussion of Article 24. For the relevant US entity classification rules, see 7.2.4. Where the UK regards the US partnership as "transparent" but the US does not, a UK foreign tax credit should be available anyway to a UK-taxpaying partner subject to the conditions in fn 673.

the *Anson* situation is an undoubted weakness[676], although the Supreme Court ultimately relied on findings of fact regarding the members' profit entitlements under Delaware law, so as to give double taxation relief for the US tax on the entity's profits (see 2.14).

The US Treasury Technical Explanation has some further interesting comments[677] on how the US regards the Exchange of Notes as operating in respect of Article 24. Firstly, it discusses the effect of the Exchange of Notes in cases involving real property, where primary taxing rights with respect to real property income must rest with the contracting state where that property is located[678]. It gives the following example:

> "….a UK unlimited liability company ("ULC") with U.S. resident partners derives gain from the sale of U.S. real property. The ULC has elected to be treated for U.S. tax purposes as a partnership and, therefore, the U.S. taxes the U.S. resident partners on the gain derived. However, because the United Kingdom treats the ULC as a company resident in the United Kingdom, the saving clause…..ensures that the United Kingdom may continue to tax the company as a U.K. resident. Because the notes provide that the United States retains primary taxing rights with respect to real property located in the United States, the United Kingdom will treat the tax paid by the U.S. resident partners as having been paid by the ULC[679] for the purposes of providing the foreign tax credit to the ULC with respect to the gain derived from the sale of U.S. real property."

The US Treasury Technical Explanation also discusses how Article 1(8) and Article 24 apply in relation to trusts. As in the UK (see Chapter 2), some US trusts are taxable as such while in the case of others, income and gain are attributed to the "grantor" (i.e. the "settlor")[680]. Furthermore, US-taxpaying beneficiaries of trusts can be taxable on underlying trust income. Unrelieved double taxation issues can potentially arise where one contracting state seeks to tax trust income at, say, the level of the trust itself or in the hands of its beneficiaries, while the other contracting state seeks to tax the same income at grantor level. In this regard, the Technical Explanation states:

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676 Similar criticisms have been made of the new Article 1(2) of the OECD Model, which closely resembles Article 1(8): see "Some Reflections" op. cit. at pages 357-8.

677 Op. cit. on pages 95-6. As already mentioned, being a unilateral publication of the US Treasury, the Technical Explanation lacks the status, for interpretation purposes, of the Exchange of Notes itself. However, there is no equivalent UK publication and its insights are therefore interesting. It has recently been cited as relevant for treaty interpretation purposes (in a different context) in *Royal Bank of Canada v HMRC* [2020] UKFTT 267 (TC) at paragraphs 39-40. For other reasons, the taxpayer's appeal was unsuccessful.

678 "Real property" has an expanded definition here because of Article 13(1) of the 2001 treaty. In particular, it includes certain indirect real property interests: on the US side, a "United States real property interest" under the FIRPTA legislation and, on the UK side, certain shareholdings, partnership or trust interests deriving their value from UK real estate.

679 This scenario is quite similar to *Bayfine* [2011] EWCA Civ 304, but, unlike that case, the Exchange of Notes expressly requires the UK to give credit for the US tax imposed on the US members of the ULC in respect of the US real property gain. This part of the Exchange of Notes should in fact be consistent with the normal UK approach. In particular, when giving credit for non-UK tax against UK tax on chargeable gains, the UK requires that the income or gain arise or accrue in the relevant non-UK jurisdiction and that non-UK tax be computed by reference to the same gain as the UK tax. However, the UK does not require that the UK and non-UK tax liabilities should arise at the same time nor that they should be charged on the same person: see Section 9 TIOPA and Statement of Practice 6/88.

680 For further discussion of the US tax treatment of trusts, see 7.2.2.

"…..A U.S. company pays interest to a U.S. complex trust ("UST") with UK beneficiaries. The UST is treated for U.K. tax purposes as a fiscally transparent entity. …..the U.K. beneficiaries claim an exemption from U.S. withholding tax with respect to that interest. However, because the United States treats the UST as a taxable entity resident in the United States….., the saving clause …….ensures that the United States may continue to tax the trust as a U.S.-resident. Pursuant to the notes, the United Kingdom will treat the tax paid by the UST as having been paid by the U.K. beneficiaries for purposes of providing a foreign tax credit to the U.K. beneficiaries with respect to the interest income[681].

……If a trust is a grantor trust for U.S. tax purposes, the income of the trust is included in the income of the U.S. grantor, and the grantor is taxed on the income. However, for U.K. tax purposes the trust income may be included in the income of the beneficiaries of the trust so that the beneficiaries pay tax on the income in the U.K. **Thus each country will have a different view regarding the identity of the taxpayer……**[emphasis added]. The notes provide that if the person taxed by one State is the grantor of the trust and the person taxed in the other State is a beneficiary of the trust, the tax paid or accrued by the beneficiary will be treated as if it were paid or accrued by the grantor for the purposes of determining the relief from double taxation allowed by the State of which the grantor is a resident. Thus, in the case of the trust described above, the United States would provide a credit to the U.S. grantor for the U.K. tax imposed upon the U.K. beneficiaries of the trust. An exception to this special rule applies with respect to an item of income from real property……or gain from the alienation of real property……[In that case] the tax paid by the resident of the Contracting State in which the property is located will be treated as if it were paid by the person who is a resident of the other Contracting State."

6.4.4 *The limits of Article 1(8), etc*

As one would expect, Article 1(8) is consistent with US tax treaty policy since the 1996 version of the US Model Treaty abandoned the "partial residence" approach reflected in Article 4 of the 1975 UK-US treaty. Article 1(8) provides a way of avoiding double taxation or double non-taxation without one contracting state's entity classification rules prevailing over those of the other. So long as the members of a "tax transparent" entity resident in the non-source state are liable to tax on a current basis in respect of an item of income derived via that entity from the source state, the latter should in principle be prepared to give treaty relief. This is subject to any other preconditions for relief set out in the wider body of the treaty, and to the right of the source state to decide the incidence and timing of source state taxation. This is consistent with the Partnership Report and with Article 1(2) of the OECD Model and the related Commentary.

Article 1(8) is of course similar to Article 1(2) of the OECD Model and Article 3(1) of the MLI, even though it long predates, and provides the inspiration for, both. There is no attempt to define what is meant by "fiscally transparent" for the purposes of Article 1(8)[682]. Apparently, the US withholding tax regulations under Section 894(c) Internal Revenue Code 1986 regard an entity as "tax transparent" only if holders of interests in it must treat its underlying income as theirs regardless of distributions,

[681] Giving a UK foreign tax credit for US tax paid on the US-source interest in these circumstances is consistent with standard UK foreign tax credit policy: see fn 679.

[682] The limited guidance on this topic in the Commentary on Article 1 of the OECD Model may be of some help: that part of the Commentary postdates the 2001 UK-US treaty, although it does develop aspects of the Partnership Report which predates the 2001 treaty.

and the character and source of the holders' income is determined by the original item of underlying income[683]. In fact the focus on "fiscal transparency" is something of a distraction. What is important when deciding whether the source state should grant treaty relief is whether the members of the intermediate entity are liable to current taxation in respect of their shares of its income for whatever reason. That may be because the entity is regarded by a contracting state as "fiscally transparent" in the fairly narrow sense described above in the US withholding tax regulations. However, the source state should be prepared to grant treaty relief if the entity is not regarded as "fiscally transparent" in this way but its members are currently taxable on its income, at a non-preferential rate, for other reasons e.g. under a "controlled foreign company" or "grantor trust" income attribution regime. In that case, too there is no unintended double non-taxation in respect of the income item. This point is not fully reflected in the 2001 treaty but the Exchange of Notes obliquely recognises it (on the UK side) by expanding the concept of "tax transparency" to include some of the UK's anti-deferral rules in respect of the income and gains of non-UK entities[684]. Such rules should ensure liability to full current taxation of the entity's underlying income at the level of its members, without relying on a "tax transparency" theory of the kind mentioned in the US Section 894(c) regulations.

Article 1(8) also leaves unresolved some of the other issues arising in respect of Article 4(1)(b) of the 1975 UK-US treaty. In particular, it only provides a limited "look through" of the "tax transparent" entity. Suppose that two UK-resident companies set up a UK partnership (in which they share 50:50) to own 100% of a US subsidiary which then pays dividends. It is not clear that Article 1(8) disregards the partnership sufficiently to enable each of the UK-resident corporate partners to claim the 5% rate of US withholding tax under Article 10(2)(a) on the basis that it is the "beneficial owner" of shares representing at least 10% of the voting power of the US subsidiary[685]. Article 1(8) also does not resolve other issues which can equally arise in relation to Article 1(2) of the OECD Model: see 6.1.6, 6.1.8, 6.1.10 and 6.1.12.

Thirdly, Article 1(8) does not attempt to resolve a number of other potential entity classification conflicts which could arise elsewhere in the 2001 treaty, and especially in the distributive Articles of the treaty dealing with taxing rights over particular forms of income. These are discussed further in 6.8.

Lastly, Article 1(8) does not interfere with the characterisation and quantification of income by the state of source, nor the persons which it taxes and when it taxes them. The source state's rules prevail in that regard even if the other contracting state might have characterised and/or quantified that income differently e.g. by treating the income in question as interest rather than a dividend. In this respect, Article 1(8) foreshadows Article 1(2) of the OECD Model and Article 3(1) of the MLI.

Before leaving the 2001 treaty, it should be noted that it is not affected by the UK being a signatory to the MLI, to which the US is not a party.

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683 See "Avery Jones: Partnerships" op cit. at 430.
684 See the discussion in 6.4.2 above.
685 At the end of Article 10(10), there is a special "look through" rule which treats a "pooled investment vehicle" holding a partnership interest as thereby owning directly a proportion of the partnership's interests in real property. There is nothing so explicit in Article 1(8) and it is doubtful (see 5.2) whether a partner "beneficially owns" specific items of partnership property, even if the partnership lacks legal personality.

6.5 The unique approach of the 2008 UK-France treaty to "tax transparent" entities[686]

6.5.1 *Introduction: the French taxation of partnerships*

The UK and France concluded a double tax treaty (SI 2009/226) which took effect in the UK from April 2010. It is notable for an expanded Article 4 ("Residence") which deals in particular with "any partnership, group of persons or any other similar entity" (hereafter "**partnerships**"). Both the UK and France are parties to the MLI but this part of Article 4 is not intended to be altered by the MLI[687].

France has historically adopted an unusual position regarding the taxation of partnerships. In particular, it regards a partnership (especially a French partnership) as a taxable person in its own right even though the partnership's tax liability on its income is collected from the partners; and the liability of each partner in respect of that income will be computed taking into account the personal circumstances and tax attributes of that partner (e.g. whether the partner is an individual or a company). This approach is usually described in French legal literature as treating partnerships as "translucent". Hence under French domestic law, a non-resident partner in a French partnership will be taxable in France even if that partnership earns purely passive income and has no French "permanent establishment"[688]. That partner is not entitled to treaty protection from French tax, unless the treaty specifically provides otherwise. To that extent the French partnership is "opaque". By the same token, France regards French partnerships as "resident in France" for the purposes of its tax treaties. France does not accept that income simply "flows through" a partnership to its partners, even though the partners are liable to be taxed on their share of the partnership's income in accordance with their personal circumstances. France reserved its position accordingly in the Partnership Report, and has usually required specific provisions in individual tax treaties concluded by it in order to give effect to the conclusions of the Partnership Report[689]. These ideas are reflected in

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[686] See in this regard, De Boynes and Howard: "Treatment of Partnerships in the 2008 France-UK Tax Treaty" [2009] Tax Notes International Volume 54 Number 5 at 401; and John F. Avery Jones: "The Revised UK-France Tax Treaty" (2008) 62 Bulletin for International Taxation No. 10 page 457.

[687] See the synthesised text of the UK-France treaty published by HMRC at www.gov.uk/government/publication/france-tax-treaties (accessed 15 December 2019). In particular, France has relied on Article 3(5)(a) of the MLI to disapply Article 3 to all of its tax treaties which are otherwise affected by the MLI: see France's instrument of ratification, etc dated 26 September 2018 in the section headed "Signatories and Parties to the Multilateral Convention to implement tax treaty related measures to prevent base erosion and profit shifting" at www.oecd.org. (accessed 15 December 2019).

[688] This was the case in the decision of the Conseil d'Etat in *Re Societe Kingroup Inc.* Case No. 144211 (1997/98) 1 OFLR 399. The French entity in that case was a "groupement d'interet economique" ("GIE"), which had legal personality and received royalty income, but which was not liable to French tax in its own name. A Canadian-resident member of the GIE could not rely on the France-Canada treaty to avoid French tax on its share of the GIE profits derived from those royalties.

[689] In November 2010, France published a proposal for reform of its tax treatment of partnerships. This reform was abandoned but had it come to pass, France would have regarded certain non-French partnerships "equivalent" to French partnerships as fully "transparent" where their French-source profits were regarded as the profits of the partners, both in the jurisdiction where the partnership was formed and in the jurisdiction where the partners were resident. Therefore, non-French-resident partners would have been able to claim treaty protection from French tax unless the partnership was carrying on business through a French "permanent establishment". This treatment would only have been available to partnerships established in EU Member States or in a third country with a double tax treaty with France providing for comprehensive information exchange. See pages 113 and 115 of "Hybrid Entities and the EU Direct Tax Directives" ed. G.K. Fibbe and A.J.A Stevens. Wolters Kluwer; and also "Proposed Legislation on French Tax Treatment of Partnerships" – Sullivan & Cromwell LLP 19/11/2010 www.sullcrom.com (accessed 29 June 2020).

the 2008 treaty with the UK and in particular Article 4(5). France clearly does not intend to change its stance in the light of Article 1(2) of the OECD Model and Article 3 of the MLI.

Since *Kingroup,* the Conseil d'Etat has shed further light on what "translucence" means and how far it extends. In 1999, in *Re SA Diebold Courtage* Case No. 191191[690], the Conseil d'Etat **was** prepared to "look through" a "closed" **Dutch** limited partnership (a "besloten commanditaire vennootschap" or "CV"[691]), whose partners were Dutch-resident private limited companies ("BVs"). It relied on the fact that, while the CV itself was not liable to Dutch tax and, importantly, lacked legal personality, this was not true of its Dutch-resident corporate partners who could therefore be treated, under Article 12 of the then France-Netherlands treaty, as receiving the French-source royalties earned by the CV.

This decision initially seems at odds with *Kingroup,* because the French court "looked through" the non-French partnership. However, the decision related to a non-French partnership lacking legal personality, as noted by the Conseil d'Etat in its 2014 decision in *Re Artemis SA* Case No. 363556[692]. In the latter case, the court decided that the French "participation exemption"[693] did not apply where a French-resident taxpaying company owned almost all of a Delaware general partnership which in turn owned more than 10% of a US corporation. In particular, that exemption only applied to dividends paid directly to the French company from the other company. That condition was not met because the interposed general partnership had legal personality under Delaware law, unlike the CV in *Diebold*. The fact that it was "tax transparent" in the US was irrelevant. The US-France tax treaty regarded US-source dividends as being distributed to the French partner in the Delaware partnership to the extent of its partnership share. However, this fell short of treating those dividends as paid "directly" for the purposes of the French domestic "participation exemption".

In deciding whether a non-French partnership is not just "translucent" but may be "looked through" for French income tax purposes, it therefore seems very important whether that partnership has legal personality under its governing law (whether or not it is a taxable entity under any non-French law to which it may be subject)[694]. The fact that the analysis turns on whether there is legal personality is not ideal, not least because different jurisdictions may interpret this concept differently. For example, some jurisdictions (e.g. the UK) are likely to regard an entity with full legal capacity to own assets and incur rights and liabilities as thereby being a legal person. Others may not regard full legal capacity as synonymous with legal personality, as seems for example to be the case regarding certain German and Dutch entities[695].

The concept of "translucence" has been further analysed as follows by one Luxembourg commentator[696]:

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[690] (2000) 2 ITLR 365.
[691] See also 7.3.2.
[692] 17 ITLR 582. See in particular the analysis of *Diebold* at page 600 in the "conclusions" of the Rapporteur Public, Emmanuelle Cortot-Boucher. These "conclusions" are not the judgment of the Conseil d'Etat as such but rather a detailed opinion on the questions at stake. This is intended to assist the court in reaching a decision. In *Artemis,* the court reached a decision which was consistent with those "conclusions".
[693] Articles 145 and 216 Code General des Impots.
[694] See 2.9.5 for a discussion of the problems which arise for UK entity classification purposes, if one focusses on whether an entity has legal personality or not.
[695] See the findings of fact regarding the Dutch VOF mentioned in the UK Court of Appeal decision in *Rowan Companies Incorporated v Lambert Eggink Offshore Transport Consultants VOF* [1998] CLC 1574.
[696] Jean Schaffner: "Droit Fiscal International". Editions Promoculture (2005) at page 582.

"Fiscal translucence is what would be considered in Luxembourg as fiscal transparency[697], namely a calculation in common of the profits of the partnership, which are then divided among the partners for the purpose of taxing them. Each partner is taxable according to the particular rules applicable to his tax situation….. [extract translated from French by the author]".

This commentator identifies two competing schools of thought regarding "translucence". The first sees there as being a single tax debt of the partnership, which is then simply collected from the partners. This school of thought seems to be articulated by Professor Jean-Pierre Le Gall in part I.A.3 of his General Report on the Worldwide Taxation of Partnerships for the 1995 Congress of the International Fiscal Association. It comes close to seeing the partnership as opaque, which seems to go too far. The second school sees "translucence" as a two-stage process, whereby the tax base and the nature of the partnership's income are worked out at partnership level but where each partner is then taxable individually, by reference to its circumstances, on its share of the partnership profits ascertained at stage one. The second school of thought seems a more accurate analysis. This differs from the classic "opaque" entity, which is a taxpayer in its own right in respect of its own separately computed income tax base, and whose tax base and tax liability are unaffected by the tax characteristics of its members.

Even though this second school of thought defines "translucence" in a manner which more closely resembles what other jurisdictions (including the UK) would regard as income tax "transparency", "translucence" nevertheless regards the partnership, obliquely, as having its own tax liability, even if this is collected from the partners and even if it reflects each partner's personal circumstances. Hence the court in *Kingroup*[698] regarded the Canadian partner in the French GIE as being liable for French tax on its share of the entity's income, even though there was no French "permanent establishment". The partner was liable for its share of what, indirectly, was the tax liability of the GIE itself.

There is one limited situation in which France regards an entity as being fully "transparent". This entity is a "societe immobiliere de copropriete", whose role is to acquire or build property to be leased to, or otherwise used by, its members[699]. The Luxembourg commentator quoted earlier states[700]: "Despite their legal form, [such entities] have no fiscal personality separate from their members. The latter are treated as owning the entity's assets directly, in proportion to their rights in the entity [extract translated from French by the author]"[701]. Hence France reserves the concept of tax "transparency" for the (rare) situation where an entity is literally "looked through" for tax purposes and where its members are treated as having a direct share in the entity's underlying assets and income stream, and not just in its net profit computed at entity level. The closest UK analogy to this type of "transparency" is the capital gains tax treatment of "bare" trusts under Section 60 TCGA

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[697] It also seems very similar to the way in which the income profits of a partnership are taxed in the UK and which is regarded for UK tax purposes as a form of tax "transparency", even though the tax base is first established at partnership level: see, in particular, Sections 846-858 ITTOIA. The rather different form of "transparency" for taxing partnership chargeable gains in the UK is discussed in Appendix A. Article 8 Code General des Impots is regarded as codifying the "translucency" principle, in respect of both French and non-French partnerships: see 17 ITLR 582 at 593, 604.

[698] (1997/8) 1 OFLR 399.

[699] See Article 1655ter Code General des Impots.

[700] Jean Schaffner, op. cit. at page 583.

[701] There is a similar analysis in the "conclusions" of the Rapporteur Public in *Artemis:* see 17 ITLR 582 at 593-4.

or of partnerships under Sections 59-59A TCGA (see Appendix A). This is yet another reminder that "transparency" can mean different things in different contexts, and that one jurisdiction's concept of "transparency" may be broader or narrower than that of another. Indeed a single jurisdiction may, concurrently, use several different meanings of "transparency", in different situations.

This uniquely French thinking strongly influences the UK-France double tax treaty.

6.5.2 *Article 3*

Article 3(1)(e) and (f) define "person" and "company" in the same way as the OECD Model.

6.5.3 *Article 4: general*

Article 4(1) provides a definition of a "resident of a Contracting State" which is very similar to Article 4(1) of the OECD Model. However, Article 4(4) then provides[702]:

"The term 'resident of a Contracting State' shall include where that Contracting State is France any partnership, group of persons or any other similar entity:

(a) which has its place of effective management in France;
(b) which is subject to tax in France; and
(c) all of whose shareholders, associates or members are, pursuant to the tax laws of France, personally liable to tax therein in respect of their share of the profits of that partnership, group of persons or other similar entity".

This of course reflects France's stated position on the "translucence" of French partnerships and on the treatment of partnerships under double tax treaties. It is not clear what is meant by a partnership, etc being "subject to tax in France". In particular, the more normal formulation "liable to tax" is not used. The discussion above of "translucence" suggests that Article 4(1)(b) is hinting at the idea that a "translucent" partnership has, obliquely, a tax liability, even though this is given effect (see Article 4(1)(c)) as the personal tax liability of shareholders, associates or members in respect of their share of the entity's profits. Presumably Article 4(4) does not extend to a "societe immobiliere de copropriete" which France regards as fully "transparent", and not merely "translucent".

Article 4(4) should also be read in the light of paragraph 3 of the Protocol where the French-resident partnership has a UK "permanent establishment" (which would ordinarily entitle the UK to tax the profits of that "permanent establishment" under UK domestic law). In that case, that "permanent establishment" is to be regarded as a "permanent establishment" of each member of the partnership who is entitled to the benefits of the 2008 treaty. Hence, in this particular situation, "translucency" is replaced with full "transparency"[703]. The same applies in the converse situation i.e. a UK partnership with a French "permanent establishment". It is rare to find an example in a UK tax treaty of the

[702] This kind of provision now exists in a number of French treaties e.g. Article 4(6) of the France-Japan treaty: see "Treatment of Partnerships in the 2008 UK-France Treaty" op. cit. at page 402 fn 11. It did not exist in the previous UK-France treaty.

[703] This is consistent with paragraph 81 Example 12 of the Partnership Report. The majority view in that Report, with some hesitation, was that the activities of that "permanent establishment" should also be attributed to the partners.

"permanent establishment" of a partnership or trust being expressly attributed to those with an interest in the entity[704]. However, this approach make sense.

The 2008 treaty does not attempt to define "partnership" and the English courts in particular have had difficulties characterising entities which France would regard as partnerships[705]. The use of the phrase "partnerships, groups of persons or any other similar entity" should go some way to ensuring that such characterisation conflicts do not cause problems applying Article 4.[706] In particular, the breadth of that phrase should limit the situations where each state finds it necessary to fall back on its domestic law to interpret the treaty, as per Article 3(2). An unresolved question is whether this phrase covers trusts, which are now capable of existing under French law too. Given recent pronouncements by the CJEU regarding trusts[707], there is much to be said for applying this phrase to a trust, at least if it makes profits and has at least two trustees.

6.5.4 *Article 4(5)*

This contains six scenarios and sets out how the 2008 treaty should apply to each. The outcomes broadly reflect the Partnership Report. This detailed approach is consistent with the French reservation to that Report mentioned earlier.

6.5.4.1 *Article 4(5)(a)*

> "….an item of income, profit or gain:
>
> (i) derived from a Contracting State through a partnership, group of persons or other similar entity that is established in the other Contracting State; and
> (ii) treated as the income of beneficiaries, members or participants of that partnership, group of persons or other similar entity under the laws of that other Contracting State;
>
> shall be eligible for the benefits of the Convention that would be granted if it were directly derived by a beneficiary, member or participant of that partnership, group of persons or other similar entity who is a resident of that other Contracting State, to the extent that such beneficiaries, members or other participants are residents of that other Contracting State and satisfy any other conditions specified in the Convention, without regard to whether the income is treated as the income of such beneficiaries, members or participants under the tax laws of the first-mentioned State".

In this scenario, the source state does not recognise the transparency of the partnership "established" in the other Contracting State, while that other State does recognise its transparency. In practice, because France does not regard partnerships as "transparent", this scenario will apply where the source state is France and the partnership is "established" in the UK. The outcome in this scenario is consistent with the Partnership Report, Article 1(2) of the OECD Model and Article 3(1) of

[704] As in many Australian treaties, there is a similar provision in the UK-Australia treaty of 2003, dealing with the "permanent establishment" of a trust: see Brabazon op. cit. at page 233.
[705] See *Dreyfus v IRC* 14 TC 560, discussed at 2.10.
[706] Although paragraph 3 of the Protocol only applies to "partnerships".
[707] See the discussion in *Trustees of the P Panayi Accumulation and Maintenance Settlements v HMRC* (Case C-646/15) [2017] STC 2495.

the MLI. It should not give rise to unintended double non-taxation. In particular the source state grants treaty relief and accepts the characterisation of the partnership by the other contracting state, precisely because the partners resident in that other state are currently liable to tax on their share (distributed or otherwise) of the partnership income and gains[708].

Interestingly, the words “fiscally transparent” are not used as such, unlike Article 1(8) of the 2001 UK-US treaty, Article 1(2) of the OECD Model and Article 3(1) of the MLI. Article 4(5)(a)(ii) appears to apply even if the other Contracting State did not regard the partnership as “transparent” but nevertheless taxed the partners currently on its income via a CFC-type regime or other income attribution regime[709].

Like the other limbs of Article 4(5), Article 4(5)(a) also applies on a “per item of income” basis. This is useful if the entity in question is only partly “tax transparent” in the non-source state. A good example would be where the income of a trust is partly subject to a vested interest in possession and partly subject to a discretionary and accumulation trust. Article 4(5)(a) should apply to those items of income which are caught by the vested interest in possession and (presumably) treated as the income of the holder of that interest by the non-source state.

There is also no definition of when a partnership is “established” in a Contracting State. The views of France and the UK may not coincide in this regard. One view is that it is enough for a partnership to be “established” in a Contracting State if it is formed under the law of that state[710]. However, given the relative ease with which the governing law of a partnership may be changed, this would be a weak nexus with a contracting state for treaty purposes. A better approach would surely be to read “established” as connoting some level of senior management activity in the relevant Contracting State. This is also consistent with the wider context of the treaty and, in particular, Article 4(4), which was discussed in 6.5.3. Article 4(4) focusses on the place of “effective management” of a partnership and not on its governing law.

Paragraph 3 of the Protocol discussed above will permit a French “permanent establishment” of the UK partnership to be attributed to the partners, which may correspondingly limit their treaty relief under Article 4(5)(a).

Article 4(5)(a) shares some of the weaknesses of Article 1(8) of the 2001 UK-US treaty, and of Article 1(2) of the OECD Model and Article 3(1) of the MLI. It does not disregard the partnership altogether. Consequently, it is not clear that two UK-resident corporate partners, sharing 50:50 in a UK partnership owning a French company, can claim the special nil rate of French withholding tax on dividends, which applies under Article 11(1)(c) where the “beneficial owner” of those dividends is “a company liable to corporation tax which **holds, directly or indirectly**, [emphasis added] at least 10 per

[708] Apparently, the treaty in this respect provides legal underpinning for the practice of the French tax authorities, in Guideline 4 H-5-07 published in March 2007 following the decision in *Diebold* supra: see BOI-INT-DG-20-20-20-10, para 110 (for dividends) and BOI-INT-DG-20-20-30, para 120 (for interest and royalties). However, unlike the treaty, those guidelines only apply where the French-source income is interest, dividends or royalties: see “Treatment of Partnerships in the 2008 France-U.K. Treaty” (op. cit.) at page 404.
[709] So long as that regime deems the partners to receive the actual underlying income of the partnership. This would not be so, in particular, under the UK CFC regime (see *Bricom Holdings Ltd v IRC* [1997] STC 1179). However, it can be the case under the rules for attributing chargeable gains of non-UK-resident “close companies” in Sections 3-3G TCGA 1979.
[710] This is the view expressed in “The Revised UK- France Tax Treaty”, op. cit.

cent of the capital of the company paying the dividends". Arguably the words "directly or indirectly" save the day for the UK partners. The position may also be improved by the decision in *Artemis*[711] mentioned earlier. In that case, it was the legal personality of the Delaware general partnership which prevented the French domestic participation exemption from applying. If the UK partnership is an English general or limited partnership (but not a UK LLP), then it will lack legal personality under English law. In that case, a French court may find it easier to accept that a UK-resident corporate partner in that partnership "holds, directly or indirectly" shares in the underlying French company[712].

6.5.4.2 *Article 4(5)(b)*

This states that "an item of income, profit or gain:

(i) derived from a Contracting State through a partnership, group of persons or other similar entity that is established in the other Contracting State; and
(ii) treated as the income of that partnership, group of persons or other similar entity under the tax laws of that other Contracting State;

shall be eligible for the benefits of the Convention that would be granted to a resident of that other Contracting State, without regard to whether the income is treated as the income of that partnership, group of persons or other similar entity under the tax laws of the first-mentioned State, if such partnership, group of persons or other similar entity is a resident of that other Contracting State and satisfies any other conditions specified in the Convention".

This approach is consistent again with the Partnership Report: see Example 5. The characterisation of the partnership in the source state is ignored, and treaty relief made available in the source state to the partnership, provided that it is taxable in the other state and regarded as resident there for treaty purposes (which it should be on the basis that it is a "body of persons", and hence a "person", "established" in the other state, thereby satisfying Article 4(1)).

This is a sensible answer because, again, there is no risk of untended double non-taxation if the source state's characterisation of the partnership is set aside in this way.

These rules again do not clarify the meaning of "established". If the UK is the source state, a French partnership should satisfy Article 4(5)(b) because French domestic tax law treats it as "translucent", not "transparent" and it should be a "resident of France" under Article 4(4) so long as its "place of effective management" is there. On the basis of *Kingroup*[713], third-country partners in the French partnership should be subject to French tax on their shares of the partnership's income, whether or

[711] 17 ITLR 582.
[712] Such an approach would resemble to some extent *Diebold* 2 ITLR 365, although that case did not address whether shares could be "held" through the Dutch CV. Of course this approach would probably not work if the UK partnership were a Scottish partnership, which has legal personality even though it is not a body corporate. This highlights the flaw in the French approach of attaching such importance to whether or not a partnership has legal personality under its governing law: the presence or absence of legal personality has limited practical impact on the way in which English and Scottish partnerships conduct business. See fn 590 regarding the (greater) scope for tracing corporate affiliation through a "transparent" partnership for the purposes of relieving double taxation on distributed profits under the EU Parent-Subsidiary Directive.
[713] See 6.5.1.

not it has a French "permanent establishment". This reduces the risk of the UK effectively giving treaty benefits to third-country residents via the French partnership.

What if France is the source state? French domestic rules on entity classification lack clarity. However, unlimited liability of members tends to be an important criterion when deciding that an entity is a partnership. Suppose that French-source income is paid to a UK-resident unlimited company. The latter is clearly taxable as a body corporate in the UK; it is not a partnership for UK tax purposes; and should be regarded as a "resident of the UK" for treaty purposes. Does this mean that it is not a "partnership, group of persons or other similar entity" at all so that Article 4(5)(b) does not apply? If that is correct, the unlimited company can rely on all other relevant treaty protections; and, if it receives dividends on a 10% or greater shareholding in a French company, it can claim the Article 11(1)(c) nil withholding tax rate because, on UK principles, it is a "company subject to corporation tax". This is the best answer from the unlimited company's perspective, especially as the dividend income is likely to be exempt under UK domestic law[714]. However, it is not clear which state's definition of "partnership" should determine what "partnership" means in Article 4(5)(b)[715]. Arguably, France's should prevail because the relevant income is French-source. However, even if it does, there is nothing in the treaty to prevent the unlimited company from also being a "company" for Article 11(1)(c) purposes. In particular, the treaty definition of "company" in Article 3(1)(f) does not carve out "partnerships" as such, and covers a UK unlimited company.

Article 4(5)(b) does not address the situation where, for example, UK-source passive income is paid to a French partnership (regarded by the UK, if not by France, as "tax transparent") whose partners are resident in a third country, which has a double tax treaty with the UK and which also regards the French partnership as "tax transparent". However, as the UK generally has no domestic withholding tax on dividends, and the 2008 treaty provides for nil withholding on interest and royalties, it is less likely that the members of the French partnership would want to invoke the treaty between the UK and the third country. It would of course be different if the third-country treaty provided better reliefs from UK tax than the UK-France treaty[716].

6.5.4.3 *Article 4(5)(c)*

This provides that "an item of income, profit or gain:

(i) derived from a Contracting State through a partnership, group of persons or any other similar entity that is established in that Contracting State;

(ii) treated as the income of the beneficiaries, members or participants of that partnership, group of persons or other similar entity under the tax laws of the other Contracting State; and

[714] See Part 9A Chapters 2-4 CTA 2009.

[715] The phrase "group of persons or other similar entity" in Article 4(5)(b) seems inadequate anyway to describe an unlimited company which has full corporate personality, with a clear distinction between the rights of the entity and those of its members.

[716] In that situation, the Partnership Report indicates that both the UK-France treaty and the UK-third country treaty would apply. Consequently, the source state should grant the more generous of the two relief packages available under these treaties. Not all countries accept this approach because of concerns about possible claims for two lots of treaty relief and, in particular, two tax refunds. See also 6.1.10.

(iii) treated as the income of that partnership, group of persons or other similar entity under the tax laws of the first-mentioned State;

can be taxed under the tax laws of the first-mentioned State without any restriction".

This scenario recognises, in particular, the fact that France regards a partnership as a taxable person. Hence, if French-source income is paid to a French partnership, that is perceived as an entirely domestic matter which should not give rise to treaty relief in France[717]. This is so even if the other contracting state regards the partnership as transparent, some of the partners are resident in that other state and are currently taxable there on their shares of partnership income. The issue is not one of double non-taxation but of fiscal sovereignty: France is not willing to accept the UK transparency analysis if that would render cross-border a situation which France regards as purely domestic.

A UK-resident partner in the partnership will therefore be taxed in France without restriction, even in respect of purely passive income of the partnership. This is consistent with *Kingroup*[718]. Paragraph 5 of the Protocol preserves the concurrent right of the UK to tax the UK-resident in respect of his partnership share. It also confirms that this income will be treated as having a French source for UK foreign tax credit purposes.

The scenario can also apply in theory in the converse situation where UK-source income is paid to a UK entity regarded as non-"transparent" by the UK but "transparent" by France. However, this is harder to envisage because the French concept of "translucency" means that France will typically not regard Article 4(5)(c)(ii) as being satisfied in respect of the UK entity. (ii) might however be satisfied if, under a CFC-type regime, France treated its residents as entitled to the actual underlying income of the UK entity, which was treated as non-"transparent" in the UK. In that case, the UK tax charge would be fully preserved.

As noted elsewhere[719], this scenario seems to be based on example 17 in the Partnerships Report. However, that example presupposes an entity in the state of source which is fully non-"transparent", whereas Article 4(5)(b) envisages, if France is the state of source, a French entity which is instead "translucent", rather than non-"transparent". Because of this, some commentators have taken issue with the solution in Article 4(5)(c)[720]. In particular, they regard this situation as cross-border, not purely domestic, because the French partnership pays no tax but its partners do, whether or not they are French-resident. This criticism is partly justified because, under French law, the computation of the partnership's tax liability in a "translucent" situation fully reflects the tax characteristics of the partners themselves[721]. Furthermore, partners are taxed on their allocated share of partnership

[717] There is no comprehensive "saving" clause in the UK-France treaty akin to Article 1(4) of the UK-US treaty, Article 1(3) of the OECD Model or Article 11 of the MLI. In the Article 4(5)(c) scenario, the broad effect of such a "saving" clause is replicated, but there is no equivalent of, say, Article 1(5) of the UK-US treaty, or the carve-outs in Article 11(1) of the MLI which preserve some treaty provisions protecting a resident taxpayer.
[718] See 6.5.1.
[719] See "Treatment of Partnerships in the 2008 France-U.K. Tax Treaty" op. cit. at 406.
[720] See "Treatment of Partnerships in the 2008 France-U.K. Tax Treaty" op. cit. at 406.
[721] In particular, this is the case (i) when the partner is a corporation subject to French corporate income tax; or (ii) when the partner is an individual conducting a business activity who has booked his partnership share as an asset on the balance sheet of that person's enterprise: Article 238 bis K of the French Tax Code – see the country report on France by Anne-Sophie Coustel in "Cahiers de droit fiscal international: Qualification of

profit whether or not it is distributed. In short, the French tax law outcome does not treat the partnership as an entirely separate taxpayer from its partners. On the other hand, *Kingroup* means that the French tax liability of the non-French-resident partner arises whether or not there is a French "permanent establishment" so to that extent the partnership is "opaque". Therefore, Article 4(5)(c) is consistent with the fact that "translucency" falls short of full "transparency".

Once again, the words "established" and "partnership" are not defined in this scenario.

6.5.4.4 *Article 4(5)(d)*

This provides that "an item of income, profit or gain:

(i) derived from a Contracting State through a partnership, group of persons or other similar entity that is established in that Contracting State; and
(ii) treated as the income of that partnership, group of persons or other similar entity under the tax laws of the other Contracting State;

shall not be eligible for the benefits of the Convention."

This scenario is based on example 6 in the Partnerships Report. The thinking is that treaty relief should be denied in cases which would otherwise trigger unintended double non-taxation, not least where income derived through a partnership, etc "established" in the source state is not currently taxed at the level of partners resident in the other state, because the latter does not perceive it to be "transparent".

While the basic principle is understandable[722], Article 4(5)(d) is excessively wide. In particular, if the partnership is a general partnership established in the UK but some or all of the partners are individuals[723] resident in France, France will in fact tax such a partner on its share of the partnership income because the partner is taxable on a worldwide basis. In such a case, there is no risk of double non-taxation[724], yet treaty benefits are still denied, creating possible double taxation. It is also doubtful whether France will grant the French partner relief for UK tax on the income of the UK partnership, unless the UK partnership has a UK permanent establishment. If it is a UK limited partnership deriving only investment income from the UK, there may well be no UK permanent

taxable entities and treaty protection" Volume 99b (2014) page 335 at 336. See also the discussion of "translucency" in 6.5.1.

722 Apparently, before this provision was introduced, there was potential double non-taxation where a French-resident was a member of a UK LLP, which was seen as a partnership for UK tax purposes but as a company in France because of its members' limited liability. Article 4(5)(d) now entitles the UK to deny treaty relief in such cases and France will give the French-resident LLP member no credit for that UK tax where there is a distribution from the LLP. To complicate matters further (!), France has apparently chosen to tax French-resident members of a UK LLP which is a law firm on the basis that the LLP is a partnership, not a company for French tax purposes. For further detail, see "Treatment of Partnerships in the 2008 France-U.K. Tax Treaty" op. cit. at pages 407.

723 Where the partners are French companies subject to corporate income tax, then income from the UK partnership is not taxed under the French "territoriality" principle.

724 See "Treatment of Partnerships in the 2008 France-U.K. Tax Treaty" op. cit. at 407-8. This situation is the converse of *Kingroup,* where France taxes the share of profits of a non-French-resident partner in a French partnership, whether or not the partnership has a French "permanent establishment": see 6.5.1.

establishment. If there is one, paragraph 3 of the Protocol treats the French partners themselves (rather than the partnership) as having that permanent establishment, any income from which will then be exempt in France.

Article 4(5)(d)(ii) does not cater well for the situation where the partnership, etc is regarded as non-"transparent" in the other contracting state (so that (ii) is satisfied) but nevertheless its income can be currently taxed at partner level under a CFC-type regime. Where this is the case, there is no double non-taxation and it is not clear why treaty benefits should be denied.

Once again, "established" is not defined.

6.5.4.5 *Article 4(5)(e)*

This provides that "an item of income, profit or gain:

(i) derived from a Contracting State through a partnership, group of persons or any other similar entity that is established in a State other than the Contracting States; and
(ii) treated as the income of the beneficiaries, members or participants of that partnership, group of persons or other similar entity under the tax laws of the other Contracting State **and under the tax laws of the State where the entity is established** [emphasis added];

shall be eligible for the benefits of the Convention that would be granted if it were directly derived by a beneficiary, member or participant of that partnership, group of persons or other similar entity who is a resident of that other Contracting State, to the extent that such beneficiaries, members or participants are residents of that other Contracting State and satisfy any other conditions specified in the Convention, without regard to whether the income is treated as the income of such beneficiaries, members or participants under the tax laws of the first-mentioned State provided that the State where the partnership, group of persons or other similar entity is established has concluded with the first-mentioned State an agreement containing a provision for the exchange of information with a view to the prevention of fiscal evasion."

This scenario covers certain cases where the partnership is "established" in a third country. Treaty benefits remain available in the source state so long as **both** the state of the partnership's "establishment" **and** the other contracting state regard the partnership as "transparent". Furthermore, there must be an effective exchange of information agreement between the source state and the third state where the "partnership" is "established". It is not clear why it is necessary for both the third state and the other contracting state to regard the partnership as "transparent"[725]. Surely the views of the third state on "transparency" should be irrelevant? Indeed, if it is a tax haven (which is common) it may not have any views on this issue. The EU law implications of Article 4(5)(e) are discussed in 6.8.7.5.1 below.

The word "established" is not defined. Furthermore, similar comments to those made in relation to Article 4(5)(a) apply. In particular, is Article 4(5)(e)(ii) satisfied if the partners, etc are subject in the

[725] Apparently, the January 2009 protocol to the tax treaty between France and the USA does not require the third state in this triangular scenario to regard the partnership as "transparent".

other contracting state to a CFC-type regime in respect of the partnership income? Is the effect of Article 4(5)(e) to treat partners as owning the partnership's underlying assets (e.g. in order to invoke Article 11(1)(c))? It is doubtful if the effect of Article 4(5)(e) is that far-reaching.

6.5.4.6 *Article 4(5)(f)*

This provides that "an item of income, profit or gain:

(i) derived from a Contracting State through a partnership, group of persons or any other similar entity that is established in a State other than the Contracting States; and
(ii) treated as the income of that partnership, group of persons or other similar entity under the tax laws of the other Contracting State;

shall not be eligible for the benefits of the Convention."

Therefore if the partnership is "established" in a third state, there is no treaty relief if it is not "transparent" from the perspective of the contracting state which is not the source state.

This scenario resembles example 7 in the Partnerships Report (at paragraphs 68-9). It is a logical extension of Article 4(5)(d). It should not be possible to sidestep the latter by setting up a partnership in a third state. As in all the other cases, "established" is not defined.

As in Article 4(5)(d), the phrasing of (ii) does not deal clearly with the situation where the third-country partnership, etc is regarded as non-"transparent" in the other contracting state but its income can be currently taxed at partner level under a CFC-type regime in that other contracting state. Where this is the case, it is not clear why treaty benefits should be denied by the source state.

6.5.5 *Conclusion on UK-France treaty*

The 2008 UK-France treaty is a notable example of a fairly recent UK double tax treaty which regulates in some detail the availability of treaty relief where the two contracting states have different views on the classification of entities and their tax "transparency" or otherwise. The treaty reflects in particular the special position of France regarding the taxation of partnerships, which led to France's reservation in the Partnerships Report and which it has maintained ever since. However, Article 4(5) is unsatisfactory in a number of respects. Specific criticisms aside, its approach to granting treaty relief at source is restrictive bearing in mind the slender distinction between the French concept of "translucency", and what many other jurisdictions regard as "transparency", when taxing entity income at member level. Now that the approach of the Partnerships Report has been made more explicit and extended via Article 1(2) of the OECD Model and Article 3(1) of the MLI, Article 4(5) of the UK-France treaty looks even more restrictive.

6.6 The approach of the 2009 UK-Netherlands tax treaty[726] to "tax transparent" entities

6.6.1 This treaty took effect in the United Kingdom from April 2011. It defines a "person" and a "company" in the same way as the OECD Model.

[726] SI 2009/227.

Similarly, Article 4(1) defines a "resident of a Contracting State" as "any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof".

6.6.2 *Article 22*

However, Article 22(2) to (4) contain a number of explicit provisions regarding partnerships and "fiscally transparent" entities, no doubt reflecting the Dutch reservation in the Partnerships Report about not applying the approach of that Report without explicit treaty language[727]:

> "(2) Where a resident of a Contracting State is a member of a partnership established under the laws of the other Contracting State, nothing in this Convention shall prevent the first-mentioned Contracting State from taxing that resident on his share of any income, profits or gains of that partnership.
>
> (3) In the case of an item of income, profit or gain derived through a person that is fiscally transparent under the laws of either State, such item shall be considered to be derived by a resident of a State to the extent that the item is treated for the purposes of the taxation law of such State as the income, profit or gain of a resident.
>
> (4) Where, by virtue of paragraph (3)…., an item of income, profit or gain is considered by a State to be derived by a person who is a resident of that State and the same item is considered by the other State to be derived by a person who is a resident of that other State, that paragraph shall not prevent either State from taxing the item as the income, profit or gain of the person considered by that State to have derived the item of income.
>
> (5) The competent authority of a State may grant the benefits of the Convention to a resident of the other State with respect to an item of income, profit or gain, even though it is not treated as income, profit or gain of the resident under the laws of that other State, in cases where such income would have been exempt from tax if it had been treated as the income of that resident."

While both the UK and the Netherlands are parties to the MLI, the Netherlands in particular has made a reservation under Article 3(5)(d) of the MLI, which preserves Articles 22(3) to (5). They therefore continue to apply as per Article 3(6) of the MLI, notwithstanding the general "transparent entity"

[727] Apparently, less than ten of the ninety or so Dutch tax treaties have language similar to Article 22, although this includes the Dutch treaties with the USA, Japan, Germany and Belgium as well as the treaty with the UK. The 2001 Netherlands treaty with Belgium is regarded as providing the most comprehensive resolution of double taxation/non-taxation issues in relation to hybrids. Its language differs somewhat from Article 22. For further detail, see Verhoog & Breuer: "Hybrid Entity Issues in a Tax Treaty Context: OECD Approach versus Actual Tax Treaties" op. cit.; and Molenaars, Michael L.: "The Tax Significance of Legal Personality: a Dutch View" – Tax Review No 316 (December 2014), at 4.2. The Netherlands-Belgian treaty is also discussed in Avery Jones: Partnerships op. cit. at pages 431-6.

clause in Article 3(1). The Netherlands has also reserved the right not to apply the "saving" clause in Article 11 of the MLI to its tax treaties[728].

Article 22(2) is of course the reversal of *Padmore* which is now a standard feature of UK double tax treaties. It does not define a "partnership" so, "unless the context otherwise requires", Article 3(2) presumably requires that concept to be defined by reference to the domestic law of the state which wishes to tax its resident's partnership share. As Article 22(2) aims to fully uphold that state's right to tax its resident, it would be strange if the context did otherwise require[729]. There is considerable overlap anyway between Article 22(2) and the partial "saving" clause in Article 22(4).

Articles 22(3) and (4) are similar to Article 1(8) of the 2001 UK-US treaty[730], and to Article 1(2) of the OECD Model. However there is no equivalent of the Exchange of Notes in the UK-US treaty which develops the scope of Article 1(8), interprets it and clarifies (in part) how the elimination of double taxation provisions should work where each contracting state taxes the same item of income in the hands of the same or a different person. Therefore, the issues already discussed in relation to the 2001 UK-US treaty are at least as pertinent in relation to the 2008 UK-Netherlands treaty, but resolving them is less straightforward.

The extent of the "look through" permitted by Article 22(3) is also limited. Hence it is not clear whether, if shares in a Dutch company are owned by a UK partnership whose two partners are UK-resident companies, those partners can claim the nil dividend withholding rate in Article 10(2)(b)(i). This would require, in particular, each corporate partner to "control, directly or indirectly, at least 10 per cent of the voting power in the company paying the dividends".
That may not be the case under the partnership arrangements and Article 22(3) does not provide for the "fiscally transparent" entity to be disregarded altogether. It also does not provide for a "permanent establishment" of that entity to be attributed to its members.

There is no equivalent in the UK-Netherlands treaty of the general "saving" clause in Article 1(4) of the UK-US treaty, or in Article 1(3) of the OECD Model and Article 11 of the MLI. However, Article 22(4) fulfils a similar function in relation to a fiscally-transparent entity. Indeed, it goes further because, in particular, Article 1(4) of the UK-US treaty is qualified by Article 1(5) which allows a resident a limited number of treaty protections. Article 1(3) of the OECD Model and Article 11 of the MLI offer a resident similar protections. There is no equivalent limitation on the scope of Article 22(4).

Article 22(5) is unusual in UK double tax treaties. It provides a route to treaty relief, via the competent authority procedure, where, for example, income is derived via an entity (a "reverse

[728] See www.oecd.org/tax/tax treaties/ Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS/Signatories and Parties (MLI Positions)/ the Netherlands – beps-mli-position-netherlands-instrument-deposit.pdf. (accessed 7 January 2020).
[729] For a recent case where the context did otherwise require, but in the different context of the UK's right to tax employment income of non-UK-residents, see the Supreme Court decision in *Fowler v HMRC* [2020] UKSC 22 regarding the interaction between the "Business Profits" and the "Employment Income" Articles of the 2002 UK-South Africa treaty. For a discussion of the implications, see Nigel Doran: "Analysis – Fowler: employment or treaty deemed trade?" Tax Journal, Issue 1490, 8 (5 June 2020).
[730] Article 22(3) is identical to Article 24(4) of the US-Netherlands treaty: see page 229 of "Hybrid Entities and the EU Direct Tax Directives" ed. G.K. Fibbe and A.J.A Stevens. Wolters Kluwer. Article 22(3) does not address the situation where the relevant entity is not "transparent" but its members are still currently taxed on its income because of a "controlled foreign company" regime or equivalent.

hybrid") which is regarded as "transparent" in the source state but non-"transparent" in the state where the entity's members are resident. Such a situation would normally be regarded as creating a risk of unintended double non-taxation, in which case the source state would look to deny treaty relief at source[731]. However, Article 22(5) recognises that this risk falls away if the income would have been exempt anyway in the member's hands, even if the entity had been "transparent" in the state where its members are resident[732]. Article 22(5) could apply for example where a UK-registered tax-exempt pension fund derives Dutch dividend income via an entity which the Netherlands regards as "transparent" but the UK does not. Interestingly, the UK tax authorities have now said they are willing to include an equivalent relaxation to Article 22(5) in the UK domestic anti-hybrid mismatch rules in Part 6A TIOPA.[733]

The UK and the Netherlands have in fact used the competent authority procedure to agree that certain fund vehicles should be regarded as "transparent" for treaty purposes. For example, an August 2010 agreement relates to a Dutch form of mutual account called a "closed" FGR ('fondsen voor gemene rekening')[734]. That agreement states that "since a closed FGR is fiscally transparent, all income and gain derived by the fund from the fund assets are allocated to the investors in the closed FGR in proportion to their participations in the fund." The agreement envisages that, in some cases and subject to safeguards against duplicate claims, the fund manager or depositary should be able to make treaty relief claims on behalf of the investors. The Netherlands has a policy of seeking such agreements with its treaty partners.

A similar agreement dated September 2014 gives a similar result in relation to certain UK Common Investment Funds deriving income and gains from the Netherlands[735].

6.7 The approach of the 2006 UK-Japan tax treaty to "tax transparent" entities

6.7.1 The UK-Japan treaty (SI 2006/1970 as amended by a 2013 Protocol) took effect from April 2007 for UK tax purposes. It originally had bespoke wording in Article 4(5) addressing a number of the issues addressed in the UK-US treaty, the UK-France treaty and the UK-Netherlands treaty. However, that wording differed in its approach, compared to those other treaties. In any case, both the UK and Japan have agreed to apply Article 3(1) and (3) of the MLI in lieu of Article 4(5). Article 3(1) closely reflects Article 1(2) of the OECD Model. Article 3(3) is the truncated "saving" clause which permits

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[731] Unless of course the entity was a taxable resident, in its own right, of the contracting state which was not the state of source.

[732] In "Some Reflections", op. cit. at pages 324-6, the authors note, and regret, the lack of a provision like Article 22(5) in the OECD proposals leading to Article 1(2) of the OECD Model. They also suggest, more controversially, that such a provision should extend to an item of income which would not be recognised anyway in the state of a member's residence (e.g. a deemed dividend in the source state), even if one ignored entirely the "fiscally transparent" entity. It is less clear that the Article 22(5) approach should apply to a situation like this, which is an income classification mismatch. Such mismatches have been a fertile source of tax planning.

[733] Part 6A was also adopted in response to BEPS Action 2 and the proposed relaxation is discussed in a 19 March 2020 Consultation Document: "Hybrid and other Mismatches" at page 13: see https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/873562/Consultation_Hybrid_and_other_mismatches.pdf. (accessed 30 June 2020). If adopted, this relaxation would apply where non-tax exempts (notably, pension funds) are members of a "reverse hybrid" entity, although the UK may wish to deny this benefit to some non-UK tax exempts. Which ones remains to be seen.

[734] See fn 632 and 7.3.2 for further detail on the nature of a FGR.

[735] Such Funds typically act as a pooled investment vehicle for the assets of UK registered pension schemes or charities.

each contracting state to tax its own residents without regard to the "transparent entity" clause. Japan (unlike the UK) has chosen not to apply to its treaties Article 11 of the MLI[736] This contains a more elaborate "saving" clause which still permits residents of a contracting state to claim treaty relief from residence-based taxation in limited cases.

6.7.2 *Article 3(1): "person" and "company"*

These concepts are defined along OECD Model lines. The UK-Japan treaty does not define a partnership.

6.7.3 *Article 4(1): "resident of a Contracting State"*

Here again, the OECD Model is broadly followed. In particular, "the term 'resident of a Contracting State' means any person who, under the laws of that Contracting State, is liable to tax therein by reason of his domicile, residence, place of head office or main office, place of management, place of incorporation or any other criterion of a similar nature". It also includes national and subnational governments of the UK and Japan; pension funds; and certain tax-exempt charitable organisations.

6.7.4 *Article 4(5): hybrid entities*

The former Article 4(5) read:

> "For the purposes of applying this Convention:
>
> (a) an item of income, profit or gain:
>
> (i) derived from a Contracting State through an entity that is organised in the other Contracting State; and
> (ii) treated as an item of income, profit or gain of the beneficiaries, members or participants of that entity under the tax laws of that other Contracting State;
>
> shall be eligible for the benefits of the Convention that would be granted if it were directly derived by a beneficiary, member or participant of that entity who is a resident of that other Contracting State, to the extent that such beneficiaries, members or participants are residents of that other Contracting State and satisfy any other conditions specified in the Convention, without regard to whether an item of income, profit or gain is treated as an item of income, profit or gain of such beneficiaries, members or participants under the tax laws of the first-mentioned Contracting State.
>
> (b) An item of income, profit or gain:

[736] For further details of the MLI positions of the UK and Japan, see www.oecd.org/tax/tax treaties/ Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS/Signatories and Parties (MLI Positions)/ Japan – beps-mli-position-japan-instrument-deposit.pdf and the United Kingdom – beps-mli-position-united kingdom-instrument-deposit.pdf. (accessed 7 January 2020). See also the synthesised text of the UK-Japan treaty reflecting the MLI-related changes and published by HMRC at https://www.gov.uk/government/publications/japan-tax-treaties (accessed 7 January 2020).

(i) derived from a Contracting State through an entity that is organised in the other Contracting State; and
(ii) treated as an item of income, profit or gain of that entity under the tax laws of that other Contracting State;

shall be eligible for the benefits of the Convention that would be granted to a resident of that other Contracting State, without regard to whether an item of income, profit or gain is treated as an item of income, profit or gain of the entity under the tax laws of the first-mentioned Contracting State, if such entity is a resident of that other Contracting State and satisfies any other conditions specified in the Convention.

(c) An item of income, profit or gain:

(i) derived from a Contracting State through an entity that is organised in that Contracting State; and
(ii) treated as an item of income, profit or gain of that entity under the tax laws of the other Contracting State:

shall not be eligible for the benefits of the Convention."

Article 4(5) focussed on the contracting state where an entity was "organised" (cf the word "established" in the UK-France treaty). "Organised" seemed to refer to the jurisdiction whose law governed the entity, rather than the place where it was managed. Following the changes per the MLI, it is no longer relevant where an entity or arrangement is "organised". Indeed it does not matter if it is "organised" in a third state. To this extent, the replacement of Article 4(5) is helpful to taxpayers.

The words "fiscally transparent" were not used in the old Article 4(5), as compared to Article 1(8) of the 2001 UK-US treaty and of course the UK-Japan treaty as amended by Article 3(1) of the MLI. This meant that, in the situation described in Article 4(5)(a), even if the entity organised in the other Contracting State was not "transparent", treaty relief in the source state was still available if the members of that entity were subject to a CFC-style regime which treated the income of that entity as theirs[737]. This was a sensible outcome which is less easy to reach now that Article 3(1) of the MLI has displaced Article 4(5)(a).

Article 4(5)(a) applied a "look through" approach to the intermediate entity by treating the entity's members as deriving directly their shares of the entity's underlying income. However, as with Article 3(1) of the MLI, it was unclear whether an affiliation by shareholding could be traced through that intermediate entity, in order to apply the nil dividend withholding tax rate. This rate applies[738] when a corporate shareholder resident in one state "has owned, directly or indirectly, shares representing at least 10 per cent of the voting power of" a company resident in the other state, for the six-month period ending when the entitlement to dividends is determined.

[737] Although treaty relief would not be available if the CFC-style regime, like the UK one, did not directly tax the income of that entity but instead used that income as a yardstick for quantifying a "sui generis" tax charge on notional income of that entity.
[738] See Article 10(3)(a).

In Article 4(5)(a) and (b), the source state's analysis of who was entitled to the income of the intermediate entity was ignored. In Article 4(5)(b), that entity was treated as a resident of the contracting state in which it was "organised", if that state treated income derived through that entity as belonging to the entity itself and also treated it as a resident. Presumably, if the members of that entity were resident in a third country which (i) had a treaty with the UK or Japan; and (ii) regarded those members as entitled to the entity's income as it arose, then those members could have also claimed the benefit of the treaty between the UK/Japan and that third country, alongside any claim by the entity itself under the UK-Japan treaty.

Article 4(5)(c) provided for the analysis in the source state to prevail, and for treaty benefits to be denied, where the intermediate entity was "organised" in the source state. This was regarded as a purely domestic situation which should fall outside the treaty, even though the entity was not required to be "resident" or "established" in the source state. However, Article 4(5)(c) also required that the other contracting state must regard the relevant income as belonging to the intermediate entity too. Hence, treaty benefits remained available if that other contracting state regarded the entity as "transparent". This was unlike Article 4(5)(c) of the UK-France treaty, where the buy-in of the non-source state is not required for this situation to be treated as purely "domestic" and hence ineligible for treaty benefits.

Article 4(5)(c) of the UK-Japan treaty has now been displaced by Article 3(1) and (3) of the MLI, which entitles each contracting state to tax its residents without regard to the "transparent entity" clause in Article 3(1) of the MLI. This is a simpler approach, although both the intermediate entity itself, and its members may be taxable in respect of the same underlying income, in their respective states of residence. Unlike the UK-US treaty, the UK-Japan treaty gives no additional guidance on how to alleviate such residence-based double taxation. This is unfortunate given the ambiguities of Article 20: see 6.7.5.

6.7.5 *Article 20*

This bespoke provision is unaffected by the adoption of the MLI by the UK and Japan. It states that, notwithstanding anything else in the treaty, income, profits or gains derived "by a sleeping partner in respect of a sleeping partnership (Tokumai Kumiai) contract or other similar contract" may be taxed in the contracting state where such income, profits or gains "arise" and according to the laws of that state.

This appears to mean that a limited partner or equivalent[739] may be taxed both in its contracting state of residence, as well as (potentially) in the contracting state which is the source of the underlying income of the partnership. The source state may for example impose withholding tax. It is not clear what the word "arises" means in this context. Article 20 seems largely to reflect Japanese concerns. Hence Japan may regard the income, profits or gains of a Tokumai Kumiai as "arising" where that

[739] "Sleeping partner" is not defined but a Tokumai Kumiai is apparently an arrangement very similar to the "stille Gesellschaft" or "silent partnership" considered in *Memec v IRC* [1998] STC 754. The closest English law equivalent is a limited partnership under the Limited Partnerships Act 1907 where the limited partner is effectively prohibited from taking part in firm management, on pain of losing its limited liability. Unlike a "stille Gesellschaft", a Tokumai Kumiai is apparently regarded by HMRC as "transparent" when taxing a UK-resident in respect of its participation in such an arrangement. The HMRC view was formed in 2005 i.e. after *Memec,* although the precise facts on which it was based are unclear: see HMRC International Manual at INTM180030.

entity is formed and managed (i.e. Japan). The limited partner will want relief for any tax on the entity's income wherever it is regarded as "arising". If the limited partner is UK-resident, and HMRC adhere to their stated position on the "transparency" of a Tokumai Kumiai, then presumably such relief will be easier to secure.

6.7.6 *Paragraph 2 of the Protocol*

This makes clear that a UK-resident partner in a Japanese partnership remains taxable in the UK in respect of his/her partnership share. This is standard wording in UK tax treaties in the post-*Padmore*[740]. It has not been removed from the UK-Japan treaty in the light of the MLI-driven changes. However, it is largely superfluous given the adoption of the "saving" clause in Article 3(3) of the MLI, which preserves each contracting state's right to tax its own residents as if the treaty were not in existence. That right is not restricted by the "transparent entity" clause in Article 3(1) of the MLI.

6.8 Conclusion on UK tax treaties and "tax transparent" entities

6.8.1 *Introduction*

Unlike France and the Netherlands[741], the UK did not register any reservations regarding the Partnership Report[742]. Therefore, the UK appears to have broadly acquiesced in that Report's conclusions and its approach to implementing them[743]: by supplementing the Commentary on the OECD Model rather than significantly changing the Model itself[744].

However, even before the 2017 changes to the OECD Model and the MLI, UK treaty making post-2000 suggests a greater willingness to address concerns regarding "transparent" entities more explicitly in the treaties themselves[745]. Yet what was achieved pre-2017 often reflected the more vocal concerns of relevant UK treaty partners. In the case of the US, the 2001 treaty dealt with these issues in detail because of US policy on tax treaties and hybrid entities, as reflected in post-1996 versions of the US Model, plus the 1997 Treasury Regulations promulgated under Section 894(c) Internal Revenue Code.

[740] [1989] STC 493.
[741] The Netherlands expressed doubts about whether the OECD Model could be interpreted in the way the Partnership Report suggested so as to lead to the Report's conclusions.
[742] For a discussion of interpretational concerns which the UK might have had with that Report's conclusions, see Murray Clayson: "OECD Partnerships Report: Reshaping Treaty Interpretation?" [2000] BTR 71. This article predates a number of UK treaties discussed here which have explicitly addressed issues dealt with in that Report. It obviously predates the post-BEPS changes now reflected in the OECD Model and the associated Commentary.
[743] See Murray Clayson op. cit. at page 71. Part 2 of the UK report in Volume 99b (2014) of the IFA Cahiers de Droit Fiscal International offers answers to a number of problem questions sent to all country reporters contributing to that volume. Those questions related to treaty entitlement where one contracting state regards an entity as "transparent" while another does not. A number of the answers in Part 2 of the UK Report suggest that the UK position is out of line with the Partnership Report, emphasising the tax analysis in the source state and not that of the state of residence of the entity's members. No further explanation or authority is given for these answers, which were not authored by HMRC. They are surprising given the lack of a UK reservation in the Partnership Report. In any case, that Report predated the post-BEPS changes to the OECD Model and the MLI.
[744] The Partnership Report proposed one change to the OECD Model: namely Article 23A(4), which requires the state of residence to give double taxation relief by credit, not exemption, where the state of source/situs relies on a treaty to exempt income or capital from tax or to reduce the rate of withholding.
[745] Maybe because of concerns about using the Commentary to the OECD Model to do all the heavy lifting.

The detailed provisions in the current treaty with France reflect France's strong reservations, expressed in the Partnership Report, about the "flow through" nature of partnerships and how treaties should address these issues. The UK-Dutch treaty reflects the Dutch view that such issues can only be effectively tackled by explicit language in a treaty. Furthermore, the bespoke provisions on "transparent" entities in the UK's treaties with the US, France and the Netherlands have not been displaced by Article 3(1) of the MLI. This suggests that these three UK treaty partners are not satisfied that the revised OECD Model and Article 3 of the MLI address their concerns in full[746].

Despite the changes ushered in by Article 1(2) of the OECD Model and Article 3(1) of the MLI, a number of other UK treaties with major trading partners remain relatively silent on these issues. For example, the UK-Italy treaty of 1988[747] simply carves out from the OECD Model-style definition of "person"[748] "partnerships which are not treated as bodies corporate for tax purposes in either Contracting State". It says nothing about how either state should treat residents of one state deriving income from the other state via an intermediate entity (which could also be a trust rather than a partnership). The much more recent 2010 UK treaty with Germany[749] also says very little[750].

The UK's treaties with Australia and New Zealand[751]have, by contrast, been amended by the MLI. In both cases the "transparent entity" clause in Article 3(1) of the MLI has been adopted, as has Article 11 of the MLI which preserves the right of each contracting state to tax its own residents while allowing such residents to invoke a limited number of treaty protections. In the case of the UK treaty with Australia, Article 11 of the MLI displaces the old Article 24 which was a variant of the usual UK treaty override of *Padmore*. The old Article 24 made clear that tax imposed in the state of residence

[746] The US is not a signatory to the MLI anyway and the relevant provisions in the 2001 UK-US treaty largely mirror Article 1(2) of the OECD Model and Article 3(1) of the MLI, while dealing more comprehensively via the Exchange of Notes with a number of related issues.
[747] SI 1990/2590. Although this treaty is regarded by the UK as a "covered tax agreement" for MLI purposes, Italy has not, as at 19 December 2019, deposited its instrument of ratification, acceptance or approval of the MLI: see www.oecd.org/tax/tax treaties/ Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS/Signatories and Parties (MLI Positions)/Italy (accessed 8 January 2020).
[748] In Article 3(1)(d).
[749] SI 2010/2975. The UK-Germany treaty is a not a "covered tax agreement" for MLI purposes: see www.oecd.org/tax/tax treaties/ Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS/Signatories and Parties (MLI Positions)/the United Kingdom – beps-mli-position-united kingdom-instrument-deposit.pdf. (accessed 8 January 2020).
[750] Article 21(2) ("Other Income") provides for "looking through" a trust or estate to its underlying income sources where the trustees or personal representatives are UK-resident and the beneficiary is German-resident. This is consistent with ESC B18 (see 4.3.5). Article 23(1)(e) also requires Germany to give double taxation relief by credit (not exemption) in certain cases where the two contracting states classify items of income differently or attribute them to different persons (cf the *Columbus Containers* case discussed in 6.8.7.3). The aim is to ensure that this conflict of classification or attribution does not lead to an artificial reduction in taxation. Incidentally, the German treaty is a very rare example of a UK treaty with a "Dividend" Article (here Article 10(2)(a)) where the lowest rate of dividend withholding is only available if "the beneficial owner is a company (*other than a partnership*) which holds directly at least 10 per cent of the capital of the company paying the dividends". The words in italics no longer appear in the OECD Model. Their logic was unclear.
[751] SI 2003/3199 and SI 1984/365 respectively. In the UK-Australia treaty, partnerships are excluded from the meaning of "person" unless they are Australian limited partnerships, which are typically taxable entities in Australia (although there is some scope for a non-Australian limited partnership to irrevocably elect for "transparent" status as a "foreign hybrid limited partnership"). For more on the latter point and its impact on the 2010 Australia-New Zealand tax treaty, see Craig Elliffe and Jun Yin: "Hybrid Entity Double Taxation: A Case Study on the Taxation of Trans-Tasman Limited Partnerships" Revenue Law Journal, Volume 21, Issue 1 (December 2011).

of a partner on its share of partnership income would be treated, for the purposes of double taxation relief, as sourced in the other contracting state. This helpful clarification has not been replicated in the treaty, as modified by the MLI. Another useful provision which is unaffected by the MLI is paragraph 3(b) of the Exchange of Notes. Where a trust is carrying on a business in a contracting state through a permanent establishment, paragraph 3(b) attributes that permanent establishment to a beneficiary resident in the other contracting state. This is a standard feature of Australian treaties (see fn 704). It partly clarifies one of the uncertainties surrounding Article 3(1) of the MLI (and Article 1(2) of the OECD Model).

The UK treaty with Canada[752] has been less heavily amended by the MLI, not least because Canada has reserved the right not to apply Articles 3 and 11 of the MLI to its "covered tax agreements"[753]. A number of existing provisions therefore remain in place. In particular, the treaty explicitly includes "trusts" and "partnerships" in the definition of "person" (and in so doing seems to regard a trust as an entity rather than just a series of obligations from trustee to beneficiary). Article 27(3) endorses the right of each state to tax its residents on their share of the profits of a "partnership, trust or controlled foreign affiliate in which that resident has an interest". Paragraph 1 of the Interpretative Protocol requires Canada to treat as fully "transparent" a UK LLP which is "effectively managed" and tax-"transparent" in the UK. However, Canada is only obliged to do this to the extent that the LLP's income is treated as the income of a UK-resident for UK tax purposes[754]. Nor does this obligation restrict the right of either contracting state to tax its own residents.

A final example of an important UK treaty which has not been significantly amended by the MLI to deal with "transparent" entities is the 1993 UK treaty with India[755], as amended by a Protocol[756]. Partnerships were explicitly carved out of the definition of "person", unless treated as a "taxable unit" in India, but this is no longer true. "Person"[757] now "includes an individual, a company, a body of persons and any other *entity which is treated as a taxable unit under the taxation laws in force in the respective Contracting* States". However, this does not mean that "a body of persons" must be a taxable unit in order to be a "person", not least because Article 4(1) now reads:

> "…..the term 'resident of a Contracting State' means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation or any other criterion of a similar nature, provided, however, that:
> (a) this term does not include any person who is liable to tax in that State in respect only of income from sources in that State; and
> (b) in the case of income derived or paid by a partnership, estate or trust, this term applies only to the extent that the income derived by such partnership, estate or trust is subject to

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752 SI 1980/709, as amended by various later Protocols.
753 See www.oecd.org/tax/tax treaties/ Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS/Signatories and Parties (MLI Positions)/Canada – beps-mli-position-canada-instrument-deposit.pdf. (accessed 8 January 2020).
754 This approach goes beyond that of Article 4(1)(b) of the 1975 UK-US treaty (supra) (see 6.3.2) and indeed of the Canadian courts in *TD Securities (USA) LLC v Her Majesty the Queen* (2010) 12 ITLR 783 (see 6.3.1). In particular, it treats the income of the UK LLP as being the income of its UK-resident members, rather than just treating the UK LLP itself as a UK treaty-resident to the extent of its UK-resident membership.
755 SI 1993/1801.
756 SI 2013/3147, which takes effect in the UK from April 2014.
757 Article 3(1)(f).

tax in that State as the income of a resident, either in its hands or in the hands of its partners or beneficiaries [emphasis added]".

The wording in the revised Article 4(1)(b) is similar to the "partial residence" approach of Article 4(1)(b) of the 1975 UK-US treaty[758], whose strengths and weaknesses have already been discussed in 6.3.2. It is also consistent with the approach of the Indian courts.[759] India seems more comfortable with this older approach to "transparent" entities: while acceding to the MLI, it has chosen not to apply Article 3 to its covered tax agreements, unlike the UK[760].

6.8.2 *Other treaty issues on entity classification: the Income from Employment Article*

There are further areas where the classification of entities, and their "transparency" or otherwise, impinges on the interpretation of UK double tax treaties. These areas remain largely untouched by recent UK treaties and case law and indeed, by Article 1(2) of the OECD Model and Article 3(1) of the MLI.

In particular, the "Income from Employment" Article raises a difficult entity classification issue in relation to exempting from tax short-stay employees resident in one contracting state who perform work in the other state. Ordinarily, that other state ("the Work State") would have the right to tax but this is subject to Article 15(2) of the OECD Model, whose material parts read:

"..remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:
(a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned; and
(b) the remuneration is paid by, or on behalf of, **an employer who is not a resident of the other State…**...[emphasis added], and
(c) the remuneration is not **borne by a permanent establishment which the employer has** [emphasis added] in the other State."

This language is the same, for example, as Article 14(2) of the UK-Netherlands treaty.

In Article 15(2)(b), how does one determine that employer's "residence" if the employer is apparently a partnership which is not itself an entity liable to tax as such? It cannot be a "resident of a contracting state" within the normal Article 4 meaning so how does one apply Article 15(2)? Should one look instead at the residence of the partners and, indeed, should the partners, not the partnership, be treated as the "employer(s)"? Treating the partners as the "employer" seems

[758] Article 25 of the UK-India treaty has now been removed, because both the UK and India have adopted the general "saving" clause in Article 11 of the MLI. Article 25 used to provide, in particular, that the UK could tax the partnership share of a UK-resident in an Indian partnership even if the latter was exempt from UK tax because of the treaty. This simply restated the UK statutory reversal of *Padmore* [1989] STC 493.
[759] See *Linklaters LLP v Income Tax Officer, International Taxation Ward 1(1)(2), Mumbai* (2010) 13 ITLR 245 and more recently, *ING Bewaar Maatschappij I BV – as trustees of ING Emerging Markets Equity Fund v Deputy Commissioner of Income Tax International Taxation Circle 2(2)(1), Mumbai* ITA No. 7119/Mum/2014.
[760] See www.oecd.org/tax/tax treaties/ Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS/Signatories and Parties (MLI Positions/India – beps-mli-position-India-instrument-deposit.pdf. (accessed 10 January 2020).

problematic because the partnership is not a "nothing", whether or not it has legal personality. There is no direct authority for disregarding it in Article 15(2) or indeed in Article 1(2) of the OECD Model. If one assumes the partnership entity is the employer, determining its residence by reference to that of its partners also creates difficulties, especially if they are resident in more than one jurisdiction[761]. Furthermore, changes in the partnership membership could mean recurring changes to the employer's residence, which would create an unstable tax position regarding relief under Article 15(2). Besides, what if one contracting state regards the partnership as "transparent" and the other does not? A compromise approach is needed[762]. The OECD Commentary hints at one in the tenth paragraph of the Commentary on Article 15(2): "While [an interpretation which focusses solely on the residence of the partners/members] could create difficulties where the partners or members reside in different States, such difficulties could be addressed through the mutual agreement procedure by determining, for example, the State in which the partners or members who own the majority of the interests in the entity or arrangement reside (i.e. the State in which the greatest part of the deduction [for employment income] will be claimed)".

In an age when major international partnerships are significant employers of internationally mobile staff, it would be much better if this approach could be embedded, for consistency, in Article 15(2) of the relevant treaty and the OECD Model, and not left to the mutual agreement procedure. Such partnerships typically have a fluctuating group of partners resident in a variety of jurisdictions. There may be no one state in which the holders of a majority of partnership interests reside. Hence a better approach would treat the partnership as **not** resident in the Work State, **provided that** no more than a specified percentage of interests in it (by value) are held by residents of that state. The precise percentage threshold should be fairly low. It makes little practical sense to disapply Article 15(2) entirely simply because a smallish percentage of interests in the partnership are held by residents of the Work State. It would also make sense to permit that percentage threshold to be accidentally exceeded by small amounts for a grace period without forfeiting relief under Article 15(2). Otherwise transitory, non-tax-motivated changes in the make-up of the partnership could prevent Article 15(2) applying[763].

[761] Although this was the approach recommended in paragraphs 88-92 of the Partnership Report and which continues to be recommended in the OECD Commentary on Article 15(2) of the OECD Model. The OECD Commentary states that its approach is consistent with Article 1(2). While true, this overlooks the rather different issues which Article 15(2) must address. In particular, Article 15(2) requires the residence of the partnership entity to be determined on an all-or-nothing basis, in order to decide whether the Work State has the right to tax, at source, an employee of the partnership, not a member of the partnership. Article 1(2) focusses instead on whether the source state can tax income derived by a particular member of an entity (e.g. a member of a partnership) through that entity.

[762] See also Loengard op.cit. at 60-61.

[763] Interestingly, Germany has added an observation to the OECD Commentary regarding Article 15(2) of the OECD Model. It considers that a partnership, and not the partners, should be regarded as an "employer" for these purposes, even if it is not a taxable entity. The partnership's "residence" would then be determined hypothetically as if it were liable to tax on the basis of at least one of the criteria in Article 4 of the OECD Model. It is not clear how this approach works if the partnership is "transparent" and a significant percentage of the partnership interests are held by residents of the Work State, even though the partnership is not "resident" in that state using the German approach. For further discussion of Article 15(2) and, in particular, criticism of the German approach, see F. Pötgens, - "Income from International Private Employment", Books IBFD, Chapter VII Sections 3.5.3, 4.3.2.1 and 4.3.3.2 (accessed 1 July 2020). It appears that Germany's approach has been reflected in some of its tax treaties, even though it is hard to justify on the wording of Article 15(2). Until 2014, Germany also included a more radical reservation on Article 4 of the OECD Model. This stated that a "transparent" partnership should generally be treated as a "resident" of the contracting state where its actual

Article 15(2) should also make clearer that, if the Work State regards the employer as being a resident taxpayer there[764], the protection of Article 15(2) should fall away anyway because the entity will then presumably be claiming a deduction in the Work State for the short-term employment income. Such an approach is consistent with the "saving" clause in Article 1(3) of the OECD Model.

If the partnership owns a "permanent establishment" in the Work State, Article 15(2) should also fall away because Article 15(2)(c) will not be satisfied. In particular, a local tax deduction is likely to be claimed in that state for the short-term employment cost, when computing the profits of that "permanent establishment", whether the partnership itself or its partners are taxable on those profits. If the partnership is the "employer" but is not a taxable entity, one can argue that it has no "permanent establishment" in the Work State for Article 15(2)(c) purposes, because a "permanent establishment" (see Article 5 of the OECD Model) must belong to an "enterprise", which (see Article 3(c)) requires the "carrying on of any business". Furthermore, in Article 7 (where the "permanent establishment" concept has greatest significance), that "enterprise" must be carried on by a "resident of a contracting state" (see Article 3(d)). The non-taxable partnership is not such a "resident" and therefore employment costs are not "borne by" it.

However, unlike Article 7, Article 15(2)(c) strictly does not require the "permanent establishment" to be owned by a "resident of a contracting state". It is enough that it is owned by the "employer". Therefore, if employment costs are attributed to ("borne by") the non-taxable partnership's "permanent establishment" in the Work State, Article 15(2) should not provide relief because Article 15(2)(c) is not satisfied. This interpretation makes better sense as a matter of treaty policy: the alternative interpretation based on Article 7 means that a non-taxable partnership employer can never have a Work State "permanent establishment" within Article 15(2)(c), in which case the Article 15(2)(c) condition can never be failed. This weakens the taxing rights of the Work State because of a technicality.

6.8.4 *Other treaty issues on entity classification: the Capital Gains Article*

Another good illustration of a treaty article which raises entity classification issues which are not fully addressed in recent UK treaties or in Article 1(2) of the OECD Model and Article 3(1) of the MLI is the Capital Gains Article. This will typically preserve the taxing rights of the contracting state in which immovable property is situated, whether that property is alienated directly or indirectly (e.g. by disposing of interests in an intermediate property-owning entity). It is in relation to such indirect disposals that entity classification issues arise.

The relevant paragraph of Article 13 (Capital Gains) of the OECD Model reads:

> "Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests [emphasis added], such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, those shares or

management is located. This went well beyond a bespoke definition of "residence" for the limited purposes of Article 15(2) and was reflected in the old 1959 Netherlands-Germany treaty.

[764] Even if, for example, the other contracting state perceives it to be "transparent" and therefore incapable of being resident there.

> comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property, as defined in Article 6, situated in that other State".

However, as paragraph 4 of the OECD Commentary on Article 13(4) anticipates, specific treaties are likely to introduce refinements, for example by broadening or narrowing the scope of Article 13 of the OECD Model. So Article 14(2) of the UK-France treaty reads:

> "Gains derived from the alienation of:
> (a) shares, other than those regularly traded on an approved Stock Exchange, or rights deriving their value or the greater part of their value directly or indirectly from immovable property …. situated in a Contracting State; or
> (b) an interest in a partnership or trust the assets of which consist principally of immovable property….situated in a Contracting State, or of shares or rights referred to in subparagraph (a) of this paragraph;
>
> may be taxed in the State in which the immovable property is situated."

The reference to "shares" in Article 14(2)(a) implies that subparagraph (a) is directed at interests in a "company", especially given the reference in Article 14(2)(b) to "an interest in a partnership or trust". There is no suggestion that the company, partnership or trust need be established in a contracting state. However, the underlying immovable property must be situated in such a state.

The two limbs of Article 14(2) are similar but not identical e.g. only the first limb contains a carve-out for stock exchange-traded members' rights. Therefore, quite a lot depends in the UK-France treaty on whether gains arise from "shares" or from "an interest in a partnership or trust"[765]. Article 13 of the OECD Model seeks to avoid these classification issues by treating "shares or comparable interests" in the same way. This is sensible, not least because there is often little real commercial difference between a company and a partnership.

The entire focus of Article 14(2) is on preserving the taxing rights of the state in which the immovable property is situated. It is consistent with that focus for that state to have the last word on whether the rights disposed of are "shares" or "interests in a partnership or trust"[766], even if its view differs from the state where the alienator of those shares or interests is resident.

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[765] The UK has created an equivalent issue in its new extended rules (effective 6 April 2019) for taxing certain capital gains of non-UK-residents disposing of interests in UK real property. This issue arises independently of any UK tax treaty. A partnership is usually "transparent" for UK capital gains tax purposes under Sections 59-59A TCGA (see Appendix A) and a "bare" trust may be "transparent" under Section 60 TCGA (see 4.3.2). Hence a disposal of an interest in a partnership or "bare" trust by a non-UK-resident typically equates to a proportionate disposal of any underlying real estate held within that partnership or trust. The same is not true where there is a disposal of a share in a company holding UK real estate by a non-UK-resident. In outline, a non-UK-resident will only be taxable under the new rules on disposing of an interest in a "company" if at least 75% of the value of that interest derives directly or indirectly from UK land. Furthermore, if the "company" is not a collective investment fund, the non-UK-resident must have had at least a 25% voting entitlement or economic equity interest in that "company" at some time in the two years leading up to the relevant disposal. For further detail, see Sections 1A, 1C, 1D, 2B and Schedule 1A TCGA. There is therefore an incentive for non-UK-residents to avoid UK tax on capital gains by holding interests in UK real property through "companies" (as defined for UK tax purposes) and not through partnerships or "bare" trusts.

[766] This seems consistent with the Partnership Report and the General Report in Volume 99b Cahiers de Droit Fiscal International: Qualification of Taxable Entities and Treaty Protection p 19 et seq. Again this issue should not arise under the wording of Article 13 of the OECD Model.

6.8.5 *Other treaty issues on entity classification: the Directors' Fees Article*

Similar points to those in 6.8.4 arise in relation to the Directors' Fees Article. Article 15 of the OECD Model reads:

> "Directors' fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the board of directors of a company which is a resident of the other Contracting State may be taxed in that other State."

Article 16 of the UK-France treaty is identically worded.

This Article also preserves the taxing rights of the source state. The relevant concepts ("company" and "a resident of the other Contracting State") are defined in the treaty itself. Hence it should be easier to identify whether the entity in question is a "company" "resident in the other Contracting State" without needing to resolve a classification conflict between the treaty partners. The reference to membership of the "board of directors" may also indicate that entities of a non-corporate nature are not covered by this Article.

What if a corporate entity is regarded as "transparent" in the state where it is established e.g. a EEIG, which (see 2.7) can in some EU Member States (including the UK) be a body corporate? Is that enough to displace the taxing rights of the source state? On one view, yes given the relevant treaty definitions. However, others apparently think that the source state should continue to tax the management fees if the entity has enough connecting factors with that jurisdiction to be resident there (ignoring the fact that it is not a taxable entity)[767]. This alternative approach has the merit of treating management fees in the same way, whether the paying entity is "transparent" or not. However, if the entity is "transparent" because it is a partnership, fees paid to its management should more logically be dealt with under the "Business Profits" Article anyway because they are effectively partnership distributions of business profits which have already been taxed.

6.8.6 *Other treaty issues: some further comments regarding trusts*

Much of the focus of this Chapter has been on "transparent" entities which are partnerships. However, treaties impact on other potentially "transparent" arrangements and in particular, trusts[768]. Depending on the nature of their beneficial interests, trusts may not be entirely "transparent" at any given time. This will be the case, for example, where part of the income of a trust is held for a fully-vested income beneficiary but the remainder of that income is held on discretionary and accumulation trusts, where no appointment of that income to beneficiaries has yet been made.

The treatment of trusts has already been discussed in relation to Article 4(1) of the OECD Model (see 6.3) and Article 1(8) of the 2001 UK-US treaty (see 6.4). The UK-US treaty makes clear that a trust is a "person". That "person" can in principle be "resident" in a contracting state because there are situations where trustees can be liable to tax by reason of domicile, residence, place of management,

[767] See the General Report in Volume 99b Cahiers de Droit Fiscal International op. cit. This echoes Germany's observations on Article 15(2) of the OECD Model: see 6.8.4.
[768] This is a large topic in its own right. For an extended discussion, see Brabazon op. cit. at Chapter 8.

etc. Of course, if and to the extent that a trust is "transparent", the trust beneficiaries may be able to claim treaty benefits directly in respect of the underlying trust income by relying on the "transparent entity" clause in Article 1(8)[769]. Article 1(8) will not prevent a contracting state taxing a trust which it regards as a resident of that state: see Article 1(4). This creates a risk of double taxation, at both trust and beneficiary level. The approach of the UK-US treaty is now largely reflected in Article 1(2) and (3) of the OECD Model, and will be increasingly reflected in UK tax treaties, mainly via Article 3 and Article 11 of the MLI.

There is limited focus on trusts in other UK treaties whose "bespoke" provisions on "transparent" entities are unaffected by the MLI. It is not clear, for example, whether "partnerships, groups of persons or any other similar entity" in Article 4(5) of the UK-France treaty covers trusts, although there seems no reason why not, at least if a trust has more than one trustee: see 6.5.3.

Article 22(3) of the UK-Netherlands treaty (see 6.6) focusses on "a person that is fiscally transparent". This more closely resembles Article 1(8) of the UK-US treaty, Article 1(2) of the OECD Model and Article 3(1) of the MLI. It is readily applicable to partnerships but may not cover all trusts[770]. In particular, it does not readily cover an accumulation or discretionary trust where income has not been appointed to a beneficiary or (?) a life interest trust where the beneficiary's income entitlement lacks the same character as the underlying income of the trust.

Article 4(1)(b) of the UK-India treaty will treat a trust as a "resident" of a contracting state if the relevant income is taxable in the hands of the trust itself or its beneficiaries resident in the relevant contracting state. As discussed, this language is similar to the "partial residence" approach to "transparent" entities of the 1980 UK-US treaty (see 6.3.2). Significantly, India has not adopted Article 1(2) of the OECD Model or Article 3(1) of the MLI. Indian trust law apparently follows the rule in *Garland v Archer-Shee*: see 4.3.3.2. Presumably, India will therefore argue that while an Indian-resident income beneficiary of an Indian trust is not taxable on the underlying trust income as it arises, any Indian-resident trustees will be entitled to that income and taxable on it. Therefore, Article 4(1)(b) of the UK-India treaty will be satisfied, provided that there are Indian-resident trustees.

None of these treaties settles explicitly whether trustees can be "beneficial owners" of income for treaty purposes (and especially for the purposes of Articles 10, 11 and 12 of the OECD Model dealing

[769] A question arises here whether a trust with a vested income beneficiary is for these purposes "transparent" if its governing law makes it subject to the rule in *Garland v Archer-Shee* 15 TC 693. Suppose the non-UK-resident income beneficiary of a trust seeks to rely on the equivalent of Article 1(2) of the OECD Model in the treaty between that person's home state and the UK (where the underlying trust income is sourced). Suppose also that the trust's governing law (which is respected in the beneficiary's home state) treats the beneficiary as having no right to the underlying income as it arises but only a right to have the trust performed, so as to make net trust income available for the beneficiary. The UK may well take the position (see fn 775 for more details) that the trust is not "transparent" for the purposes of the "transparent entity" clause in the treaty because the governing law treats the beneficiary as having an income source which is not the underlying trust income. This is similar to arguing (see 6.1.3) that a member of an entity who is taxable in respect of its income under "controlled foreign company" legislation cannot invoke the equivalent of Article 1(2) of the OECD Model in cases where that legislation does not tax the member directly on its share of the entity's underlying income but only on a surrogate amount computed by reference to that income. For reasons given in 6.4.2, that argument seems weak.
[770] See the earlier discussion of Article 1(2) at 5.2 and see also fn 769.

with dividends, interest and royalties[771]). On a narrow common law reading of the "beneficial ownership" concept, trustees cannot have "beneficial ownership". However, this concept was only introduced into the OECD Model in 1977 and is not intended to bear the common law meaning but instead an "international fiscal meaning"[772]. The better view is now that a trustee can be a "beneficial owner" for treaty purposes where that trustee is "liable to tax" on trust income in more than a "purely representative" capacity (see 6.3) and the trust is a discretionary and accumulation trust[773]. Where the trust is a pure discretionary trust (i.e. the trustees must distribute all income even if they have discretion about which beneficiaries get paid and how much), then it is harder to see how the trustees have "beneficial ownership", given their fiduciary obligation to pass on all trust income[774]. It is unlikely in practice that a discretionary trust will lack powers of accumulation.

Where the trust is a discretionary and accumulation trust, what if the trust claims treaty relief on its income on the basis that it is a "resident" and "beneficial owner" but then makes a distribution enabling the relevant beneficiary to recover tax paid by the trustees on the income funding that distribution? This can arise, for example, in respect of non-UK-source income distributed by UK discretionary trustees to a non-UK-resident beneficiary: see the discussion of ESC B18 in 4.3.5. Surely the jurisdiction in which the underlying income is sourced should be able to restrict the UK trustees from claiming treaty benefits, where that income can effectively pass tax-free to a third-country resident because of the way in which the UK taxes subsequent distributions by UK discretionary trustees?

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[771] Increasingly, the "Other Income" Article in UK treaties is importing the "beneficial ownership" condition, although not the "Capital Gains" Article.

[772] Certainly this is the view of HMRC, and is likely to be the view of the UK courts following *Indofood International Finance Ltd v JP Morgan Chase Bank NA* [2006] STC 1195. This view better respects the use, in the French version of the OECD Model, of the term "beneficiaire effectif", rather than "beneficial owner". The French and English versions have equal weight.

[773] See also Prebble: "Accumulation Trusts and Double Tax Conventions" op. cit. Prebble (whose article predates *Indofood)* notes that New Zealand has, in several treaties, made clear that dividends, interests and royalties on which a trustee is subject to tax should be treated as being beneficially owned by that trustee, although New Zealand may have insisted on this language to resolve doubt: see Avery Jones: Trusts op. cit. at page 391. There is an equivalent New Zealand reservation to Article 3 of the OECD Model. For a recent discussion to the same effect, see Brabazon op. cit. at pages 236-240.

[774] However, in the past, HMRC has accepted that a Massachusetts business trust (a form of regulated US investment fund) can be the "beneficial owner" of UK-source dividend income for treaty purposes, even though the US rules on "regulated investment companies" ("RICs") will effectively require the US entity to distribute most of its income to investors on a current year basis. The HMRC International Manual indicates, at INTM339550 (accessed 14 January 2020), that HMRC will take a more relaxed stance regarding treaty claims by the trustees of a non-UK discretionary trust if all the beneficiaries are resident in the same country as the trustees, and the settlor cannot benefit from the trust. In that case, no "treaty shopping" concern should arise and an unwelcome conclusion that there is no "beneficial owner" is avoided. Recently, the Italian Supreme Court ruled that a UK trust (apparently, an "authorised unit trust") was a "person" for the purposes of claiming benefits under the "Dividend" Article in the 1990 UK-Italy treaty. It would also be regarded as a "beneficial owner" of the dividend if it is was not "fiscally transparent" and not subject to an obligation to pass on the relevant item of income: see Tax Treaty Alert 2020/01 6 May 2020 https://www.maisto.it/en/newletter/tax-treaty-alert--87.html. As an "authorised unit trust" is not a discretionary trust, in fact it is probably subject to such an obligation.

If the charge on the trustee is purely "representative", then the "beneficial ownership" question should be addressed instead at the level of the beneficiary[775].

Of course if a trustee or beneficiary has entered into other arrangements (apart from the trust) which make it an agent, nominee or other conduit in respect of an item of income, then it will probably lack "beneficial ownership" for treaty purposes.

Trusts of course have particular relevance in relation to wealth and succession planning. The UK has a limited number of double taxation treaties which deal with estate and gift taxes. These too can raise entity classification and transparency issues. They are discussed further in Appendix C.

6.8.7 *EU law and entity classification issues*

6.8.7.1 EU law

No discussion of entity classification and "tax transparency" would be complete without considering the impact of EU law and in particular the ever-evolving case law of the CJEU regarding the four "fundamental freedoms": namely, the freedom of establishment, the freedom to provide services, the free movement of workers and the free movement of capital [776].

6.8.7.2 Lack of harmonisation re entity classification, etc

To date, EU law has not sought to impose on Member States uniform criteria for classifying entities for direct tax purposes. Furthermore, it has not sought to dictate when and how specific entities should be treated as "transparent" or not for tax purposes[777]. These are matters left to the domestic tax law of Member States.

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[775] In the International Manual at INTM339540 (accessed 14 January 2020), HMRC confirm that this is the case where a treaty claim is made in respect of a trust subject to the rule in *Baker v Archer-Shee,* which is logical. However, they also state that where the governing law of a trust is such that *Garland v Archer-Shee* [1931] AC 212 applies instead, the trustees themselves are treated as beneficial owners of the trust income "because we consider that the beneficiary's right to income from the trust is against the trustees, rather than in the underlying assets held in the trust". This approach could facilitate "treaty shopping" by third-country residents with a vested income interest in a *Garland* trust if the trustees are resident in a jurisdiction with a favourable treaty with the UK. Besides, strictly, the HMRC statement about "beneficial ownership" seems incorrect. Even under a *Garland* trust (see 4.3.3.2), the trustees have an absolute obligation to pay net trust income to, or for the benefit of, the vested income beneficiary. That is very hard to equate with the trustees being "beneficial owners" of that income for treaty purposes, post-*Indofood*. This HMRC statement is in effect concessionary. They already regard (see 6.3.1) the trustees of a *Garland* trust as being "resident" for treaty purposes, because they are not taxed in a purely "representative" capacity. If HMRC were unwilling to treat such trustees (rather than the beneficiary) as "beneficial owners", they would still be unable to claim treaty relief at source, despite being treaty-"resident", while relief would also be denied to the beneficiary of a *Garland* trust. Further proof (if proof were needed) of the flaws in the rule in *Garland v Archer-Shee*!

[776] See Articles 45-66 Treaty on the Functioning of the European Union. This section is drafted on the assumption that the UK law will remain aligned with EU law, despite the result of the 23 June 2016 referendum. At the time of writing, it is not clear to what extent this assumption is correct.

[777] If one leaves aside EEIGs (discussed in 2.7) and VAT groups (discussed in 5.4.5), as well as Article 9a of the Anti-Tax Avoidance Directive (discussed below). Article 10 of the original proposed draft of the Anti-Tax Avoidance Directive required Member States to adopt the same entity classification in a case which would otherwise lead to a double deduction or to a deduction in one Member State without any corresponding

However, several Directives regulate certain consequences of entities being treated as "tax transparent" in a Member State. This is true of the Parent-Subsidiary Directive[778], the Mergers, etc Directive[779] and the Anti-Tax Avoidance Directive[780]. As already discussed[781], these Directives adopt different approaches to defining an entity as "fiscally transparent" for their purposes. In particular, the approach of the Parent-Subsidiary Directive and the Mergers, etc Directive seems rather narrow, because it assumes that "fiscal transparency" is driven by an entity's legal characteristics. This is not always so, because in some jurisdictions (e.g. France), "transparent" tax treatment depends on whether or not an election has been made[782].

Article 9a of the Anti-Tax Avoidance Directive imposes a limited non-transparency rule in order to avoid mismatches arising in respect of a "reverse hybrid" entity within the EU. Directly addressing the entity classification mismatch in this way departs from the general approach of that Directive which (consistently with the outcome of BEPS Action 2) usually counteracts any double non-taxation risk from an entity classification mismatch, but does not eliminate that mismatch altogether by imposing on Member States a uniform entity classification. Article 9a applies, in particular, where one or more

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income inclusion in another Member State. However, this provision did not make it into the final text. For further discussion of the draft Article 10, see Parada: Article 1(2) op. cit. at pages 372-3.

[778] 2011/96/EU as amended.

[779] 2009/133/EC as amended.

[780] 2016/1164/EU, as amended by 2017/952/EU.

[781] See fn 167.

[782] A wider question arises especially in relation to Articles 9-9b of the Anti-Tax Avoidance Directive. These counteract certain tax mismatches arising, in particular, from an entity being classified differently in separate jurisdictions or being regarded as dual-resident. Article 9 in particular applies quite mechanically if certain objective conditions are met, including certain affiliation tests. Hence do these Articles restrict the "four freedoms" (and in particular the freedom of establishment and the free movement of capital) without justification? This Directive was enacted pursuant to the procedure in Article 115 of the TFEU, which contains the "four freedoms" and is the highest source of EU law. A Directive is a lesser source of EU law and must in principle respect the "four freedoms": see the comments of Advocate-General Alber at paragraph 58 of his opinion in *Bosal Holding BV v Staatssecretaris van Financien* Case C-168/01, [2003] ECR I-9409. The CJEU has to date defined quite narrowly the grounds on which a Member State can invoke the avoidance of tax as a justification for restricting the exercise of the "four freedoms": see paragraphs 65-69 of the judgment of the CJEU in *Cadbury Schweppes Overseas Ltd and Cadbury Schweppes plc v HMRC* C-196/04, [2006] STC 1908, which stress the need for the relevant arrangement to be "wholly artificial". That case related to the (then) UK "controlled foreign company" rules and the "freedom of establishment". It is not clear that Articles 9-9b of the Anti-Tax Avoidance Directive fully respect this CJEU reasoning, although in a 2019 case relating to the free movement of capital, the CJEU seemed willing to admit tax avoidance as a justification in a wider range of cases: see paragraph 84 of the judgment in *X GmbH v Finanzamt Stuttgart – Koerperschaften* Case C-135/17. At a practical level, the author doubts whether the CJEU will prove a major obstacle to implementing the Anti-Tax Avoidance Directive. For further discussion of *Cadbury Schweppes* and the tensions between it and the Anti-Tax Avoidance Directive, see Christiana HJI Panayi: "Cadbury Schweppes and Cadbury Schweppes Overseas (2006) - CFC Rules under EU Tax Law". Ch 19 "Landmark Cases in Revenue Law" ed: John Snape and Dominic de Cogan. Hart Publishing 2019. In "Advanced Issues in International and European Tax Law" Hart Publishing (2015) at pages 203-8, the same commentator sketches out arguments for the compatibility with EU law of Articles 9-9b of the Anti-Tax Avoidance Directive, taking into account CJEU thinking on the four freedoms in general, and on tax treaties in particular (see also 6.8.7.4). See also Alexander Rust: "BEPS Action 2: 2014 Deliverable – Neutralising the Effects of Hybrid Mismatch Arrangements and its compatibility with the Non-discrimination Provisions in Tax Treaties and the Treaty on the functioning of the European Union"[2015] BTR 308, where the commentator paints a rosier picture of the ability to justify BEPS 2 hybrid mismatch restrictions under primary EU law.

"associated" (i.e. related) non-resident "entities" hold in aggregate, directly or indirectly, at least 50% of the voting rights, capital interests or profit-distribution rights in a "hybrid entity"[783] which is incorporated or "established" in a Member State. In that case, if those "associated" holders are "located" in a jurisdiction(s) which regard(s) the "hybrid entity" as a taxable person, the Member State in which that entity is incorporated, etc must tax it as a resident of that State, to the extent that its income is not already being taxed either in that Member State "or any other jurisdiction". These quoted words should mean that Article 9a will apply only if a payment to the "reverse hybrid" can be deducted by the payer. Hence Article 9a ensures that the entity's income does not escape taxation at either entity level (on the basis that it would otherwise be "transparent") or at member level (on the basis that the entity is opaque in the members' home jurisdictions, so that they are not taxed on its undistributed income)[784].

The question of whether entities are "fiscally transparent" is also addressed in the October 2016 draft Directives on a Common Corporate Tax Base ("**CCTB**") and a Common Consolidated Corporate Tax Base ("**CCCTB**"). Both deal with tax mismatches arising from differences in entity classification between jurisdictions, but do not impose uniform entity classification norms nor uniform criteria for deciding whether and how an entity is "transparent". Article 62(1) of the CCTB states that where an "entity" (undefined) is treated as "transparent" in the Member State where it is "established", a taxpayer holding an interest in that entity must include in its tax base its share of the income of that entity. Article 62(2) treats transactions between such a taxpayer and that entity as, in effect, transactions between the taxpayer and third-party owners of that entity. "Transparent" and "established" are not defined for these purposes. Article 63 then provides that whether a non-EU "entity" is "transparent" is to be determined according to the law of the Member State of the taxpayer subject to CCTB.

Under Article 27 of the CCCTB, the classification of a non-EU entity in which at least two group members hold an interest is to be agreed between the relevant Member States. Classification is to be decided by the so-called "principal tax authority" if there is no agreement. Article 31 then provides how income of a "transparent" entity is to be apportioned to a member of the group (for CCCTB purposes) which holds an interest in that entity.

6.8.7.3 The "Columbus Containers" case: CJEU decisions in the context of a "hybrid mismatch"

The CJEU has to date only looked in detail at an entity classification mismatch in *Columbus Container Services BVBA & Co v FInanzamt Bielefeld-Innenstadt* (Case C-298/05) [2008] STC 2554. That case involved a Belgian limited partnership which was taxed as a separate entity in Belgium, but at a low rate because it carried on business as a so-called "co-ordination centre". The interests in the Belgian limited partnership were held directly or indirectly by German-resident members of a family. Under

[783] A "hybrid entity" is an entity or arrangement treated as a taxable entity in one jurisdiction but whose income or expenditure is treated as that of one or more other persons (i.e. it is "transparent") in another jurisdiction.
[784] There is a carve-out for widely-owned, regulated "collective investment vehicles" which hold a diversified portfolio of securities (but not real estate assets). Article 9a can be a particular problem for those holding minority interests in the entity: their tax treatment may change unexpectedly, and adversely, because of a change in the make-up of other "associated" holders of interests in that entity. By changing the tax classification of an entity because of a change in the holders of interests in that entity, Article 9a may also give rise to discrimination issues, under EU law or a double tax treaty: see Leopoldo Parada: "Hybrid Entity Mismatches and the International Trend of Matching Tax Outcomes: A Critical Approach" Intertax, Volume 46, Issue 12 (2018) 971 at 991 (hereafter, "**Parada: Hybrid Entity Mismatches**").

the Belgium-Germany tax treaty, as it then stood, there was a German exemption for income of a German resident (in this case, its share of partnership profits) which were derived and taxed in Belgium. This exemption gave rise to effective double non-taxation because of the very low rate of Belgian tax. To counteract this, Germany unilaterally overrode the tax treaty so that it only granted the German-resident partners a credit for the (low) Belgian tax on their share of partnership profits. The aim was to produce a German tax outcome similar to the outcome where a German-resident had a share in a low-taxed "controlled foreign company". The German override was challenged on the basis that it was an unjustifiable restriction on the German partners' freedom to establish in Belgium. Alternatively, it was an unjustifiable restriction on the free movement of capital.

Advocate-General Mengozzi stressed that the entity classification mismatch between Germany and Belgium was not an issue in and of itself: Member States were not required to recognise for their own tax purposes the legal and tax status conferred by other Member States on entities carrying on business in those other States[785]. However, he took the view[786] that the German treaty override was a restriction on the "freedom of establishment" of a German-resident which could only be upheld if the underlying arrangements satisfied the "wholly artificial" standard required to justify a restriction on "freedom of establishment" based on tax avoidance. The Advocate-General referred in particular to the *Cadbury Schweppes* decision[787] and was clearly unpersuaded that this standard could be met on the facts of this case. A particular concern was that the German override applied only to the extent that the income of the Belgian partnership was low-taxed passive income. Because the override was targeted in this way, the case was not simply one where an unfavourable outcome arose because of the co-existence of different tax legislation in two sovereign Member States.

The CJEU also had no issue with the underlying entity classification mismatch. However, perhaps surprisingly, it did not adopt[788] the Advocate-General's position on the four freedoms. The German override imposing double taxation relief by credit only, for low-taxed income of a non-German partnership, was not a restriction on either the freedom of establishment or the free movement of capital. All that mattered was that the profits of a German-resident from a non-German partnership were being taxed no less favourably than those of a German-resident from a ("transparent") German partnership. That condition was met. It was not relevant that Germany would not have taxed in the same way an investment by a German-resident in an entity which (by German standards) was not "transparent" (e.g. a Belgian company). Member States were free to determine how to tax different

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785 See [2008] STC at page 2563. The CJEU has also refused to apply the EU "abuse of law" doctrine to a deliberately created VAT mismatch: see *HMRC v RBS Deutschland Holdings GmbH* (Case C-277/09) [2010] ECR I-13805. In that case, UK "input" VAT on car purchases was refundable to the German leasing subsidiary of a major UK bank, even though no "output" VAT was chargeable in Germany or the UK when that subsidiary leased those cars to a UK customer of the bank. This VAT mismatch did not exploit entity classification differences but, rather, differences between the way in which the UK and Germany had transposed into domestic law the Sixth Council Directive 77/388/EEC of 17 May 1977 (in particular, Article 5). The result was that the UK regarded the car lease as a "supply" of "services" outside the UK, while Germany regarded it as a "supply" of "goods" outside Germany. The CJEU focussed in particular on the fact that lessor and lessee were unaffiliated and that the transaction, even though structured to be tax-efficient, was not "an artificial arrangement that does not reflect economic reality and the sole aim of which is to obtain a tax advantage".
786 See [2008] STC at pages 2573-2585.
787 [2006] STC 1908.
788 See [2008] STC at pages 2590-2593. The CJEU's stance has prompted at least one commentator to propose an EU Directive on Mutual Recognition of Entities within the EU. This would require mutual recognition, within the EU, of the classification of an entity in its "host" country: see Parada: Hybrid Entity Mismatches op. cit. at page 992, fn 136.

types of foreign "establishment" set up by their residents (including subsidiaries or branches) so long as such taxation was no less favourable than the taxation applying to an equivalent domestic "establishment".

The CJEU stressed[789] that there was little harmonisation at EU level regarding methods of eliminating double taxation e.g. the Parent-Subsidiary Directive 2011/96/EU and the 1990 Arbitration Convention, with the latter now being largely overshadowed by the Directive on Tax Dispute Resolution Mechanisms in the European Union 2017/1852/EU. Outside these limited areas of harmonisation, Member States were free to conclude bilateral double tax treaties. Generally, the CJEU had no jurisdiction to interpret those treaties or to rule on whether Member States had infringed the terms of those treaties (e.g. via a treaty override)[790].

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[789] See [2008] STC at page 2591.

[790] The CJEU has, however, taken into account the OECD Model and Commentary when interpreting the Interest and Royalties Directive 2003/49/EC and the Parent-Subsidiary Directive 2011/96/EC. Generally, the CJEU has regarded the four freedoms as not affecting how Member States relieve double taxation on their residents provided that a Member State taxes cross-border situations no less favourably than purely domestic situations. Whether such double taxation is relieved in whole or in part will then basically depend on the interaction between the separate domestic taxing rules of the relevant Member States. It is possible that a disparity between the rules of two sovereign Member States will lead to unrelieved double taxation. For example, in *Kerckhaert and Morres v Belgian State* (Case C-513/04) [2007] STC 1349, the CJEU did not object to Belgian taxation of its residents in respect of **all** dividends at a (lower) flat rate, with (usually) no credit for any non-Belgian tax on cross-border dividends. This approach, which led to unrelieved double taxation, was confirmed in *Damseaux v Belgium* (Case C-128/08) [2009] STC 2689, even though in that case, Belgium had overridden its own treaty-based obligation to give a foreign tax credit. The approach was also confirmed in 2009 in *Margarete Block v Finanzamt Kaufbeuren* (Case C-67/08), a German inheritance tax case where only a deduction, and not a credit was given for an equivalent tax in another Member State. More recently, the approach was confirmed in *Daniel Levy, Carine Sebbag v Etat Belge* (Case C-540/11), where it was held that there was no duty of EU loyalty to give double taxation relief. The CJEU in *Gilly v Directeur des Services Fiscaux du Bas-Rhin* (Case C-336/96) [1998] STC 1014 recognised that under Article 293 EC Treaty (repealed in 2009), Member States merely had an obligation to **negotiate** to remove double taxation. They were not required to guarantee such an outcome. *Gilly* also endorsed the allocation of taxing rights in respect of employment income in the then France-Germany tax treaty. It even accepted as non-discriminatory a rule which preserved source state taxation of public sector employment income but only where the employee was a national of both contracting states, and not just a national of the non-source state. For a critique of the CJEU's "hands off" approach regarding double taxation relief and the four freedoms, see Sandra Eden: "The Obstacles Faced by the European Court of Justice in Removing the 'Obstacles' Faced by the Taxpayer: the Difficult Case of Double Taxation" [2010] BTR 610. Another commentator has suggested (!) that, because Article 293's mere duty to negotiate has now been repealed, the CJEU should be able to apply internal market principles more vigorously to combat double taxation: see Eric C.C.M. Kemmeren: "Double Tax Conventions on Income and Capital and the EU: Past, Present and Future". EC Tax Review 2012, Volume 21, Issue 3. In reality, this seems unlikely. By contrast, where non-residents are being taxed differently from residents of a given Member State, the four freedoms may well be relevant e.g. in relation to dividend withholding taxes. It will then be important to take into account the effect of a relevant tax treaty when deciding if the non-resident is in fact being treated less favourably in the Member State concerned than an equivalent resident: see

6.8.7.4 *Other issues regarding the four freedoms and bilateral double tax treaties*

The CJEU has considered other issues regarding the impact of the four freedoms on bilateral double tax treaties between Member States. Of particular importance in this regard is *D v Inspecteur van de Belastingdienst/Particulieren/Ondernemingen buitenland re Heerlen*[791] where the CJEU ruled that the EU freedoms do not prevent Member States from entering into bilateral tax treaties allocating tax jurisdiction on the basis of nationality and residence: such treaties are a legitimate method of achieving a balanced allocation of taxing power between states[792]. Because such treaties create an overall balance of reciprocal rights and obligations between the two states in relation to their respective residents, those rights cannot simply be invoked by a third-country EU-resident on the basis of the four freedoms. To do so would amount to cherry-picking parts of the overall treaty package in a manner which would undermine the bargain between the contracting states. In short, the four freedoms do not create a form of "most favoured nation" clause in tax treaties between Member States[793]. *D* is a pragmatic response to long-expressed questions about whether double taxation treaties were inherently discriminatory against residents of Member States which were not party to the relevant treaty[794]. Hence "bespoke" provisions regarding "transparent" entities such as Article 4(5) of the UK-France treaty cannot be invoked by a national of another Member State who is not resident in the UK or France for the purposes of that treaty. Of course, with Article 3(1) of the MLI modifying many other UK treaties, this issue is likely to be less significant.

Bouanich v Skatteverket (Case C-265/04) [2008] STC 2020 and *Denkavit Internationaal BV and another v Ministre de l'Economie, des Finances et de l'Industrie* (Case C-170/05) [2007] STC 452. Quite exceptionally, in the tax treaty between Germany and Austria, the CJEU is designated as arbitrator: see *Austria v. Germany* (Case C-684/15).

791 Case C-376/03 [2006] All ER (EC) 554.

792 The CJEU noted in particular, that as per *Gilly* [1998] STC 1014, a difference in treatment between nationals of two contracting states because of a treaty-based allocation of taxing rights cannot amount to prohibited discrimination.

793 In *D,* a German-resident subject to Dutch wealth tax claimed an exemption from that tax which the Netherlands granted to Belgian-residents in its treaty with Belgium, because of the broad definition of "personal allowances" in that treaty's Non-Discrimination Article. There was no equivalent provision in the Dutch treaty with Germany. The CJEU rejected the claim, which was based on the free movement of capital.

794 *D* has been followed by the CJEU in *Test Claimants in Class IV of the ACT Group Litigation v Inland Revenue Commissioners* (Case C-374/04)[2007] STC 404. That case raised issues regarding the freedom of establishment and the free movement of capital, in respect of UK-source dividends paid to non-UK-residents. The CJEU ruled that the freedoms were not infringed simply because the UK granted a refundable "tax credit" in respect of dividends paid to residents of Member State A with which it had concluded a treaty allowing such refunds, but made no equivalent provision for refunds to residents of Member State B with which it had agreed a different treaty. Residents of Member States A were not in the same position as residents of Member State B. Furthermore, the freedoms were not infringed where the UK treaty with Member State A contained a "limitation of benefits" clause. This denied a refund to a corporate resident of Member State A which was controlled by residents of other jurisdictions whose treaties with the UK did not offer such refunds. The CJEU's approach to a "limitation of benefits" clause in *Test Claimants* has been queried, not least because of an earlier conflicting decision of the CJEU in relation to a "limitation of benefits" clause in international aviation treaties. However, that earlier case did not relate to double tax treaties: it appears to be CJEU policy to encourage Member States to make such treaties without being excessively tied down by EU law in doing so. *Test Claimants* ensures that the tax treaty package cannot be indirectly exploited by persons resident in other jurisdictions whose treaties with the UK are less beneficial. Hence it is a logical development of the thinking in *D*. For further discussion, see F. Debelva, D. Scornos, J. Van den Berghen and P. Van Braband: "LOB Clauses and EU-Law Compatibility: A Debate Revived by BEPS?" EC Tax Review 2015, Volume 24, Issue 3.

Despite the decision in *D,* residents of Member State C may sometimes be able to invoke the protection of a tax treaty between Member State A and another jurisdiction, B, in particular if the resident of Member State C has a "permanent establishment" in A. In *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v Finanzamt Aachen-Innenstadt*[795]*,* the German branch of a French company successfully relied on the "freedom of establishment" to invoke German double taxation relief under two treaties concluded by Germany with non-EU Member States. The CJEU stressed that, in neither case was the non-EU Member State being asked to give treaty relief to the French company. The latter simply claimed double taxation relief in Germany on the basis that it had exercised its EU right of establishment there by setting up a German branch, rather than a subsidiary, and that under EU law, the form of its German establishment should not negatively affect its German tax treatment. German domestic law had in fact already been changed to reflect the outcome reached by the CJEU[796].

Had the relevant treaties in *Saint-Gobain* been between Germany and other Member States, the German "permanent establishment" of the French company should also have been entitled (despite *D*) to the same treaty benefits from the source state as that state would have granted to a German-resident. Otherwise the source state would be restricting the claimant's freedom to establish in Germany through a branch rather than a subsidiary[797]. Hence, in theory, the German "permanent establishment" could claim the benefit of any "bespoke" "transparent" entity clause in the relevant Germany treaty, even though there was no such clause in France's treaty with the source jurisdiction. One commentator has suggested that source state treaty benefits in a Member State should only be available to a "permanent establishment" under *Saint Gobain* if that establishment's profits are relieved from double taxation by exemption, not credit, in the residence jurisdiction of the company to which the establishment belongs[798]. The author is unconvinced. The CJEU has not drawn such a distinction and in many cases (depending on relative tax rates), the exemption and credit methods produce an equivalent outcome. Moreover, if the residence jurisdiction of the company taxes its otherwise-exempt "permanent establishment" under a "controlled foreign company" regime (as permitted by the Anti-Tax Avoidance Directive), that in effect replaces the exemption method with the credit method.

6.8.7.5 *Unjustified UK restrictions of the four freedoms in relation to "transparent" entities?*

6.8.7.5.1 *Article 4(5)(e) of the UK-France treaty?*

[795] Case C-307/97 [2000] STC 854.

[796] On the strength of *Saint Gobain,* the UK enacted what is now Section 30 TIOPA which allows a UK branch or permanent establishment to claim UK double tax relief by way of foreign tax credit. It does not matter whether the branch or permanent establishment belongs to a national of a Member State, so in that sense the UK went beyond the strict requirements of EU law.

[797] Suppose a treaty contains a "limitation of benefits" clause denying source state benefits to a resident of the other contracting state which is controlled by one or more third entities (whether or not within the EU). Presumably those benefits should also be denied to a "permanent establishment" in that other contracting state which belongs to such a third-country entity? This seems consistent with *Test Claimants in Class IV of the ACT Group Litigation* discussed above, and maintains tax parity between a third-country-controlled branch and a third-country-controlled subsidiary.

[798] See Eric C.C.M Kemmeren: "Double Tax Conventions on Income and Capital and the EU" op. cit. at part 4.6.

Article 4(5)(e) of the UK-France treaty may restrict freedom of establishment without justification: where a partnership is "established" in a third country, source state treaty benefits are only available under Article 4(5)(e) if both the state of the partnership's establishment and the non-source contracting state regard it as "transparent". If the partnership happens to be established in another Member State which does not regard it as "transparent", the effect of Article 4(5)(e) is to render investment via that State less attractive because treaty relief is denied under Article 4(5)(e). There is no obvious justification for this, especially as the US-France treaty does not require the third state in this triangular scenario to regard the partnership as "transparent". Furthermore, ignoring this restrictive aspect of Article 4(5)(e) under EU law is proportionate because it does not upset the overall balance of the UK-France treaty. This situation is not simply one where two sovereign Member States happen to have differing views on whether an entity is "transparent". So *Columbus Container Services* (see 6.8.7.3) is not relevant. Instead, the UK and France have negotiated an additional condition which expressly restricts treaty relief by reference to the entity classification rules of a third state.

6.8.7.5.2 *The UK tax treatment of a UK LLP?*

As already discussed in 2.7, a UK limited liability partnership is in fact a form of company which is normally treated for UK direct tax purposes as a partnership. In particular members of the UK LLP within the UK tax charge can claim a share of its losses which they may be able to set against other non-LLP-related income and gains. While there are major preconditions to claiming and using LLP losses in this way, the basic principle holds[799]. Suppose that X and Y are German-residents who wish to set up a joint venture to carry on a trade solely in the UK. X and Y each have other UK income sources outside the joint venture. If their joint venture takes the form of a UK LLP and it produces losses, then each may be able to set its share of those losses against its other UK income and at the same time enjoy the benefit of limited liability. This ability to use losses while enjoying limited liability would not be available if X and Y chose to conduct their UK trade through a purpose-formed German GmbH with no other activity. The fiction which treats a UK LLP as a partnership for UK tax purposes does not apply to any other form of company, and in particular it does not apply to non-UK companies, whether or not formed within the EU. The UK rules on loss utilisation may therefore make it more favourable to establish a UK joint venture through a UK LLP rather than through, say, a German GmbH, even though both are forms of private limited company and even though both are conducting business solely in the UK. This appears to be a restriction on the freedom of X and Y to establish in the UK which is very difficult to justify[800].

6.7.8.5.3 *Imprecise nature of UK rules for classifying non-UK entities (but not UK entities) for tax purposes?*

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[799] See fn 288 and the accompanying main text.

[800] A separate question is whether the special UK tax treatment of a UK LLP could be challenged as unlawful "state aid" within Article 107 of the TFEU. This question goes well beyond the scope of this thesis but the European Commission has considered state aid issues in relation to hybrid entities. Recently it enquired into Luxembourg rulings granted in favour of McDonald's Europe, under which allocating income to a US branch of a Luxembourg company led to effective double non-taxation under the US-Luxembourg treaty. Ultimately, the Commission concluded that there was no misapplication of that treaty and hence no state aid: see Commission decision of 19 September 2018 on tax rulings SA 38945 (2015/C)(ex 2015/NN)(ex 2014/CP) granted by Luxembourg in favour of McDonald's Europe: http://ec.europa.eu/competition/elojade/csef/case_details.cfm?proc_code=3_SA_38945.

As already discussed (e.g. at 3.9), there is a major divergence in the UK approach to classifying UK and non-UK entities for tax purposes. While the approach in relation to UK entities is fairly prescriptive, the "resemblance" approach in relation to non-UK entities is much more fluid, fact-sensitive and indeed confused.

A UK taxpayer investing "outbound" in a non-UK entity may therefore have considerable problems, and a considerable administrative burden, working out its UK tax position accurately. This lack of clear, binding guidance and entity classification criteria can seriously impede UK-residents exercising their "freedom of establishment" or their right to the free movement of capital. The same is true in "inbound" situations e.g. if residents of other Member States seek to establish in the UK using non-UK entities. Not least with EU law in mind (see, for example, *Futura Participations SA v Administration des Contributions* (Case C-250/95) [1997] STC 1301) , there is surely a case for creating clearer, binding and less unnecessarily burdensome entity classification rules which apply to both UK and non-UK entities.

6.8.7.6 Mechanics of claiming treaty relief

Even if the members of an entity can claim treaty benefits from the jurisdiction where that entity's income is sourced via a "transparent entity" provision, the question remains how to go about this. The jurisdiction of source may well prefer to give such relief only by refunding tax initially withheld, rather than by giving upfront relief from such withholding. This will have cashflow implications for members of that entity, which are less likely to arise where an entity is "opaque." The issue is well explained in HMRC's International Manual at INTM335530[801]:

> "…although HMRC is willing to entertain any application for relief at source from partnerships, it should be understood that we will be likely to give relief in this way chiefly where:
>
> - We are able to obtain satisfactory assurances about the membership of the partnership.
> - The number and type of partners is not such as to cause concern in the first place – for example, a small and fixed number of participators……
>
> Where [we] conclude that relief at source cannot be authorised[802], the partnership will only be able to obtain treaty benefits on behalf of its members by making a series of repayment claims and by providing supporting evidence about the identity of its partners with each claim."

6.8.8 *Final thoughts*

It is not the purpose of a double tax treaty to impose on the two contracting states comprehensive rules on entity classification and related questions of tax "transparency". These concerns and questions are key structural issues at the heart of the domestic tax law of each state. The thinking of judges and policy makers on these issues within each jurisdiction is likely to evolve over the life of a tax treaty, which makes it even harder for these issues to be effectively addressed in a treaty and for potential classification tensions between the two states to be eliminated. The treaty merely aims to

[801] https//:www.gov.uk/INTM335530. Accessed 13 January 2020.

[802] Upfront relief at source is given at HMRC's discretion under Double Taxation Relief (Taxes on Income) (General) Regulations 1970: SI 1970/488.

ensure that these issues, and the resulting mismatches between jurisdictions, do not give rise to double taxation or unintended double non-taxation, where income flows between the two states via an entity whose classification is not the same in each state. Despite their limitations, treaty provisions such as Article 1(8) of the 2001 UK-US treaty and Article 4(5) of the 2008 UK-France treaty have helped to refocus the UK treaty network more effectively on such questions since the Partnerships Report, although the impetus for such measures has not come mainly from the UK.

Article 1(2) of the OECD Model, together with Article 3(1) of the MLI, should henceforth make that increased focus more widespread throughout the UK treaty network, even if Article 1(2) has its own weaknesses (see 6.1). Further work is needed to spell out sensible answers to rather different entity classification/"transparency" challenges thrown up by the distributive articles in a treaty (such as Article 13 (Capital Gains) and Article 15(2) (Employment Income) of the OECD Model).

Last but not least, ongoing developments in EU law (such as the Anti-Tax Avoidance Directive) may yet have a greater impact on questions of entity classification and tax "transparency" than they have done to date. There are good grounds for thinking that aspects of the UK entity classification "rules" are also vulnerable to a challenge under EU law, on the basis of the four "freedoms".

7. Entity classification issues in the USA and the Netherlands

7.1 *Introduction*

Other jurisdictions besides the UK have of course wrestled with how best to classify domestic and non-domestic entities for local tax purposes. While no tow domestic tax systems are the same, it is instructive to see how other jurisdictions have addressed such questions. In particular, such questions have been closely considered for US Federal tax purposes. The first part of this Chapter therefore focusses on the USA and the distinctive approach to these questions which it has adopted, and which the UK tax authorities (among others) are known to dislike. The second part of the Chapter looks at the contrasting approach of the Netherlands. Here civil law thinking colours the classification of Dutch and non-Dutch entities for Dutch tax purposes, although the Dutch approach has a certain amount in common with the UK approach. Neither the USA nor the Netherlands takes account of the tax treatment of a non-domestic entity in its home jurisdiction when classifying it for its own tax purposes.

7.2 ***The US entity classification rules***

7.2.1 The US Federal tax rules[803] on entity classification were significantly overhauled with effect from the start of 1997, including the introduction of the (in)famous “check-the-box” feature. However, that feature is one aspect of a much greater whole.

7.2.2 *Trust or business entity?*

The first question to ask for US tax purposes is whether an organisation or arrangement is a standalone entity separate from its owners for Federal income tax purposes (rather than just being one which is disregarded). Some arrangements (e.g. based on contract such as a Luxembourg “fonds commun de placement”) may be regarded as a separate entity for US tax purposes if the parties carry on a business and share profits (which they often do). This is so even though that arrangement would not otherwise give rise to a separate legal person for non-tax purposes or indeed for non-US tax purposes. Other arrangements (e.g. cost sharing arrangements, the relationship of lessor and lessee) may be “nothings” for US tax purposes, although the courts fight shy of treating arrangements as a “nothing”, rather than a standalone entity. Apparently, joint decision making is enough to find that a co-ownership arrangement is a business entity (and probably a partnership) for US tax purposes[804].

The question whether there is a separate entity, and if so, how many such entities, is determined under Federal tax law for Federal tax purposes, and not by reference to state law[805]. There has been some dispute about the ongoing relevance of pre-1997 court decisions on whether a separate entity exists for US tax purposes[806].

If there is a separate entity, the next question is whether it is a trust or a “business entity”. The borderline between the two is not always easy to pin down. In particular, a trust is for these purposes an arrangement created by will or “inter vivos” whereby trustees take title to property so as to protect or conserve it for beneficiaries. Nevertheless, an arrangement which is a trust from a formal legal perspective can be treated[807] instead as a separate business entity for Federal tax purposes. This is true in particular of business or commercial “trusts”, where the trustee’s role involves more than

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[803] Most states have adapted their rules, for state income tax purposes, to follow the Federal approach.
[804] See Blanchard: “The Tax Significance of Legal Personality: A US View”, New York University School of Law Spring 2015 Colloquium on Tax Policy and Public Finance at pages 18-20. The commentator suggests that the US bias in favour of recognising entities, not “nothings”, ensures that more arrangements can be brought within the rules in Subchapter K (partnerships) of the Internal Revenue Code, which prevent artificial income shifting among entity members. In the UK, co-ownership arrangements can, and often do, fall short of partnership status, and are not regarded as an entity. Rather, each participant is separately taxed on its share of income and gains. There is therefore a mismatch here between the UK and US entity classification rules, with the UK concept of partnership for tax purposes being somewhat narrower than its US equivalent, although it extends to limited partnerships which are used for passive investment (notably in the area of venture capital). Moreover, this mismatch between the UK and US rules does not stem from a “check-the-box” election.
[805] Treas. Reg. 301.7701-1(a)(1).
[806] For more detail, see the United States country report (authored by Anthony C. Infanti and Bernard Moens) in Volume 99b (2014) of the International Fiscal Association Cahiers de Droit Fiscal International, page 859 at pages 861-2. In particular, there is dispute about the relative importance of two decisions of the US Supreme Court in the 1940’s: *Moline Properties, Inc. v Commissioner* 319 US 436 and *Commissioner v Culbertson* 337 US 733. *Moline* set an especially low threshold for deciding that an entity or arrangement formed under state law was a separate entity for Federal tax purposes. In particular, all it required was a business purpose or activity.
[807] Treas. Reg. 301.7701-4(b).

simply protecting or conserving a more or less static pool of trust assets[808]. A good example is the Massachusetts Business Trust, which is a popular vehicle for the type of US collective fund known as a "Regulated Investment Company" (see also 7.2.4.1). It is usually regarded as a "business entity" (indeed a corporation) for US tax purposes.

This Chapter will not discuss in detail the US tax treatment of trusts which are not "business entities". However, the following paragraphs summarise the US Federal income tax treatment of trusts. Under the "grantor trust" rules in Internal Revenue Code Part 1, Subpart E, the income and activities of such a trust can be attributed to the "grantor". In short, such a trust is "looked through" in its entirety and the trust income and capital are regarded for Federal tax purposes as owned by the "grantor". This also applies for US estate and gift tax purposes. The "grantor" is a person having a specified degree of power over the trustee or the trust property (broadly, the equivalent of the "settlor" for UK tax purposes). However, there are limits on the attribution of income and capital to the "grantor", not least to ensure in most cases that items are attributed directly or indirectly to a US taxpayer[809].

The Internal Revenue Code also has a "simple trust" concept[810]. This is a trust other than a "grantor trust" where the trustee is required under the trust instrument to make current distributions of income and/or capital. The trust is a separate taxable unit. However, the trust income which must be currently distributed retains its character, timing and source in the hands of the beneficiaries, whether or not distributed. Therefore, there is a considerable degree of "tax transparency", although less so than in relation to a "grantor trust", because this type of trust is not "looked through" in the same way.

The Internal Revenue Code recognises a third type of trust, the "complex trust". This too is a taxable unit but the trustee has significant discretion regarding trust distributions. This type of trust is the least "transparent" of the three. However, it can deduct income distributed to beneficiaries. That distributed income retains its underlying character and source for US tax purposes in the hands of beneficiaries, although not always its timing. In particular, it is only attributed to beneficiaries in the tax year when the distribution is made (or required to be made). To the extent that the income of such a trust is not distributed in a timely manner, it is taxed in the hands of the trustees.

7.2.3 *What kind of "business entity"?*

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[808] The UK also treats certain trusts ("unit trusts") as business entities (namely, companies) for the purposes of both corporation tax and capital gains tax, as discussed in 4.3.6.2. However, whether a trust is a "unit trust" depends on the regulatory definition of a "unit trust scheme". This concept does not distinguish between those trusts which are more dynamically managed and those which are purely asset protection mechanisms: a trust which conducts a trade remains a trust for UK tax purposes, unless it is a "unit trust scheme", which is not always the case.

[809] For further details on this and other forms of US trust, see fn 73 of "Some Reflections" op. cit. See also Brabazon op. cit. at pages 32-4, 39-40 and 43-8, in relation to "grantor trusts". As is pointed out in Brabazon op. cit, at page 39, there are important exceptions (e.g. a simple revocable trust) where income can be attributed to a non-US grantor under the "grantor trust" rules. These exceptions provide tax planning opportunities. See fn 7 for similar issues under the equivalent UK rules.

[810] See Brabazon op. cit. at pages 296-300 for further discussion of the US taxation of beneficiaries of non-"grantor trusts". In some situations, time limits for making distributions need to be met if "transparent" treatment of trust income and gain at beneficiary level is to be assured.

Having identified a separate entity which is a “business entity” rather than a trust, one must decide whether it is created or organised “in the United States, or under the law of the United States or of any State” or in the District of Columbia[811]. If so, that “business entity” will be “domestic”. In some cases, certain “non-domestic” entities may elect to be treated, or must be treated as “domestic” entities for Federal tax purposes[812].

As discussed below, “domestic” or “non-domestic” status has important consequences. However, an important general point to note is that the entity classification rules for Federal tax purposes apply to both “domestic” and “non-domestic” entities, even if the way in which they apply to each category may differ. The United States is therefore unusual (unlike, say, the UK and the Netherlands) in having a single, largely harmonised set of tax rules for classifying all entities and not just those which are “foreign”. Part of the reason for this is that the United States itself is a Federal jurisdiction. It therefore requires overarching tax classification rules which can apply consistently to the various entities created under the separate commercial laws of each of the States.

7.2.4 *Classifying a “domestic” “business entity”*

7.2.4.1 *“Domestic” “per se” corporations*

The US legislation provides an exhaustive list of “domestic” business entities which are always regarded as corporations (and hence tax-“opaque”) for Federal tax purposes. Such entities are often referred to as corporations “per se”. In particular, this category includes any entity organised under a statute of one of the States which “describes or refers to the entity as incorporated or as a corporation, body corporate or body politic” or “as a joint-stock company or joint-stock association”[813].

Also regarded invariably as corporations for Federal tax purposes are insurance companies, state-chartered banks and entities wholly owned by a state or non-US government[814]. The same applies to other business entities which are specifically treated as corporations under the Internal Revenue Code, such as certain “publicly-traded partnerships”[815].

[811] But not created or organised in a US possession (e.g. Guam) or Puerto Rico.
[812] E.g. “stapled entities” (Section 269B(a)(1) Internal Revenue Code) and some “inverted corporations” created by transactions whereby a non-US corporation acquires a US corporation (Section 7874(b) Internal Revenue Code).
[813] Treas. Reg. 301.7701-(2)(b)(1),(3).
[814] Treas. Reg. 301-7701-2(b)(4)-(6). State-chartered banks for this purpose are those whose deposits are insured by the Federal Government.
[815] Section 7704 Internal Revenue Code. These must have interests which are traded on an established securities market or are readily tradeable on a secondary market. Section 7704 does not impose corporate status where the publicly-traded partnership receives predominantly passive income (e.g. interest, dividends or royalties). This has enabled certain private equity funds to list interests in entities qualifying as partnerships for US tax purposes without being caught by Section 7704. The logic of Section 7704 is open to question: why should a partnership always be treated as a corporation simply and solely because it sources capital in public markets rather than privately?

The basis for a number of these categories of "per se" corporation is the Internal Revenue Code itself, so they cannot readily be altered by Treasury Regulations. Nevertheless it is not easy to justify such blanket exclusions from the elective part of the US entity classification regime[816].

It should be added that the Internal Revenue Code, in Subchapter S, has long permitted certain small, privately-held US corporations to elect for "tax-transparent" treatment as so-called "S Corporations". A number of detailed conditions must be met before a corporation is eligible to make such an election. With limited exceptions, a S Corporation pays no US tax on its income[817].

The Internal Revenue Code also contains bespoke and largely "pass-through" taxation regimes for certain corporations engaged in specified activities e.g. Regulated Investment Companies ("RICs") and Real Estate Mortgage Investment Conduits ("REMICs"). These special regimes are unaffected by the general rules on elective entity classification[818]. In essence, they are bespoke tax regimes for collective investment vehicles, whose economic rationale would be undermined if the entity itself were subject to significant taxation on its profits.

7.2.4.2 *"Domestic" "eligible entities"*

If a "business entity" is domestic and not a "per se" corporation, then it will be an "eligible entity". In particular, this gives it scope (discussed below) to elect its US tax classification. The most important type of "domestic" "eligible entity" is the "limited liability company" or "LLC". Almost all states of the US (starting with Wyoming in 1977) have enacted legislation permitting the creation of these hybrid limited liability entities which combine the legal personality and limited liability characteristics of a corporation with the internal organisational flexibility of a partnership. The closest analogue to a limited liability company in UK law is the UK LLP (which is of course an incorporated entity without share capital which is deemed to be a partnership for certain tax purposes)[819]. In particular, LLC members' interests usually do not take the form of share capital[820].

"Domestic" "eligible entities" also include limited partnerships ("LPs"), limited liability partnerships ("LLPs") and limited liability limited partnerships ("LLLPs") formed under the laws of the various states. LPs, LLPs, LLLPs and LLCs are now largely interchangeable for US tax and non-tax purposes, although none of a LLC's members has to have unlimited liability, even nominally. Classically, a LP had to have at least one general partner with unlimited liability for the obligations of that partnership,

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[816] For a detailed discussion of this, see Heather M. Field "Checking in on Check–the-Box" 42 Loy. L.A. L. Rev. 451 (2009) http://digitalcommons.lmu.edu/llr/vol42/iss2/4 (hereafter "**Field**") at pages 505-520.
[817] Questions have been asked about the ongoing need for S Corporation status now that limited liability companies (see 7.2.4.2) can readily be set up as "tax-transparent" partnerships or disregarded entities for US tax purposes. However, S Corporations remain quite widespread. The US tax treatment of a S Corporation is similar, but not identical, to a partnership or a disregarded entity.
[818] Treas. Reg. 301.7701-1(b) and – 2(a).
[819] The author has been told in the past by leading US tax advisers that the LLC concept is also similar to the entity known as a "limitada" in, for example, Spain and Latin America.
[820] This was true for example of the LLC in *Anson v HMRC* [2015] STC 1777: see 2.14. HMRC consider that it is possible for interests in a Delaware LLC in particular to be structured as "ordinary share capital" for UK tax purposes: see 2.14.6. When tracing a UK group (e.g. for corporation tax, stamp duty and SDLT purposes) via an intermediate LLC, it will be very important to demonstrate that the LLC has "ordinary share capital" for UK tax purposes. Otherwise tracing will not be possible. Nevertheless, the idea of members' interests taking the form of share capital is largely alien to the LLC concept.

although in practice that partner's exposure could be contained. However, under the 2001 Uniform Limited Partnership Act, limited liability is apparently extended to all partners of a LP, whether or not they take part in management[821].

LLPs and LLLPs bear an even closer resemblance to LLCs, not least because all members benefit from limited liability even if they take part in firm management. What limited liability means in this regard will vary from state to state. For example, so-called "first generation" LLPs only protect innocent partners from liability for malpractice of their fellow partners. This is true of New York and California, which also limit LLP structures to professional firms. However, "second generation" LLPs go further and provide partners with a "full shield", not only from the malpractice of other partners but also from debts arising in the ordinary course of business. Delaware is such a "full shield" state although a Delaware LLP does not limit a member's liability for negligence, unlike a Delaware LLC.

A LLLP is a form of limited partnership which provides all partners with limited liability, not only for each other other's wrongdoing but also for debts arising in the ordinary course of business. Like the LLP, it continues the trend of limiting the liability of partners who take part in firm management[822].

A "domestic" "eligible entity" with more than one member can elect to be treated as a partnership or a corporation for US tax purposes[823]. If no election is made, then that entity is classified as a partnership[824], which means that it remains an entity for US tax purposes and is subject to Subchapter K of the Internal Revenue Code. A "domestic" "eligible entity" with a single member can elect to be treated as a corporation or to be disregarded for US tax purposes[825]. If no election is made, then the entity is simply disregarded[826]. Such disregarded entities are treated as a sole proprietorship (if the single member is an individual) or as a mere branch or division of the member (if the latter is an entity)[827]. This capacity to disregard altogether a single-member entity is a highly distinctive feature of the US entity classification rules. It has been heavily used to create classification mismatches with the tax laws of other jurisdictions. Where it applies, that entity's income and assets are treated as those of its member, and transactions between the entity and the member are ignored.

Entity classification elections are made on IRS Form 8832. This is effective on the date filed unless a different effective date is specified. In any case, the effective date cannot be more than 75 days' prior to the filing date nor more than twelve months after it[828]. An entity which files an election to change its existing classification cannot normally file another election changing its tax classification for sixty months following the effective date of that earlier election[829].

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[821] See Blanchard, "The Tax Significance of Legal Personality: A US View" op. cit. at page 9.
[822] For further detail, see Blanchard, "The Tax Significance of Legal Personality: A US View" op. cit. at pages 9-11. New York and California prohibit the LLLP form.
[823] Treas. Reg. 301.7701-2(a).
[824] Treas. Reg. 301.7701-3(b)(1)(i).
[825] Treas. Reg. 301.7701-2(a).
[826] Treas. Reg. 301.7701-3(b)(1)(iii).
[827] Treas. Reg. 301.7701-2(a).
[828] Treas. Reg. 301.7701-3(c)(1)(iii).
[829] Treas. Reg. 301.7701-3(c)(1)(iv). This 60-month rule does not apply to an election which is effective from the date of an entity's formation. Nor does it apply where the election is to change the entity's default classification. Equally, it does not apply to a transferee entity to which the business of another entity is transferred. The IRS also has discretion, which it has exercised by private letter ruling, to relax the 60-month limitation in individual cases.

7.2.5 *Classifying a "non-domestic" "business entity"*

7.2.5.1 *"Non-domestic" "per se" corporations*

There is a list which specifies by country a number of types of non-US legal entity which are invariably corporations for US Federal tax purposes[830]. These tend to be corporate entities in major non-US jurisdictions which can (although not necessarily do) offer their securities to the public e.g. the UK public limited company, the French societe anonyme, the German Aktiengesellschaft and the Dutch NV. Canada enjoys a slightly special status: although Canadian corporations are listed as "per se" corporations, this does not apply to any Canadian company all of whose members have unlimited liability (e.g. a Nova Scotia unlimited liability corporation[831]). In all cases, the non-US tax treatment of the entity is irrelevant when classifying it.

Importantly, this "per se" list for non-US entities leaves out a large number of corporate bodies (notably, many corporate bodies formed in tax havens), unlike the corresponding "per se" rules for "domestic" entities: see 7.2.4.1.

On the other hand, it is strange that this list includes non-US corporate entities which could offer their securities to the public, whether or not they actually do. This differs from the way in which the "publicly-traded partnership" rule operates: see 7.2.4.1.

7.2.5.2 *"Non-domestic" "eligible entities"*

Non-domestic business entities which are not "per se" corporations are "eligible entities" which can elect their US tax classification in much the same way as "domestic" "eligible entities": see 7.2.4.2. The default classifications of "non-domestic" entities are, however, different. If an entity with more than one member does not elect its classification, then it will be a corporation if all its members have limited liability and a partnership if at least one member lacks limited liability[832]. If a single-member entity does not elect its classification, then it will be a corporation if the single member has limited liability and disregarded if it does not[833]. For these purposes, "a member of a foreign eligible entity has limited liability if the member has no personal liability for the debts of or claims against the entity by reason of being a member"[834].

There is some evidence of non-US entities electing in large numbers to be disregarded for US tax purposes[835]. This may be explained in part by the different default entity classification rules which

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[830] Treas. Reg. 301.7701-2(b)(8).
[831] Treas. Reg. 301.7701-2(b)(8)(ii)(A)(1). Of course the UK also has a form of unlimited liability company. However, this is not a "per se" corporation because only a UK public limited company is a "per se" corporation and a UK unlimited company cannot, by definition, be a public limited company.
[832] Treas. Reg. 301-7701-3(b)(2)(i)(A)-(B).
[833] Treas. Reg. 301.7701-3(b)(1)(ii).
[834] Treas. Reg. 301.701-3(b)(2)(ii). This rule determines whether there is unlimited liability purely by reference to the governing law and constitutional documents under which the entity is organised. It does not take account of the actual economic capacity of an entity member to make good that entity's loss. So the "unlimited liability" condition can be met even if the entity with unlimited liability is, say, a purpose-formed company with very low net worth (so that in substance, its unlimited liability does not amount to much).
[835] See Field op. cit. at page 527.

apply to non-US entities. Under these, there are more cases where an actual election is needed to secure disregarded entity status.

The US tax classification of a "non-domestic" entity is only relevant when it affects the liability of any person for US Federal tax or information-reporting purposes[836]. However, this limitation is not that generous given the breath of US information reporting obligations (e.g. under FATCA – see fn 650).

7.2.6 *Implications of the US entity classification rules*

7.2.6.1 Building on the effective choice available under the pre-1997 rules

There is a misconception that the US Federal tax rules for entity classification are entirely elective. This is not so: the automatic "opaque" status of domestically-incorporated US business entities is similar to the way in which the UK characterises entities incorporated under UK domestic law (except UK EEIGs and the misleadingly-named UK LLP). Furthermore, the US rules mandate "opaque" status for a wide range of non-US entities. It is striking that the US rules do not mandate "opaque" status for many more non-US incorporated entities. This includes, for example, UK private limited companies, the French Sarl, the Dutch BV, the German GmbH and a number of entities incorporated in well-known tax havens. All US-incorporated entities are invariably "opaque", assuming that they are not S corporations. Hence there is an asymmetry in the treatment of US and non-US incorporated entities. To some extent, this asymmetry may be offset by the widespread availability within the US of LLCs. These are not regarded as "incorporated" under state law. Hence they are not automatically treated as "opaque".

The US is unusual in allowing taxpayers an administratively simple choice whether other "eligible entities" (US and non-US) should be treated as transparent for Federal tax purposes. The practical benefits of this choice are magnified by the widespread availability within the US of the limited liability company. This form of "eligible entity" offers an attractive combination of full legal personality, perpetual succession and member limited liability as well as great constitutional flexibility. Commercially, it is a halfway house between a "classic" partnership (including a Scottish partnership) and a corporation. Taxwise, it can decide whether it should be taxed as a corporation, a partnership or (if it has a single member) a disregarded entity. It is no surprise that so many entity classification elections relate to LLCs.

The most novel substantive effect of this elective regime is the ability to "disregard" single-member "eligible entities". Whereas a partnership is not a "nothing" for Federal tax purposes[837], a disregarded

[836] Treas. Reg. 301.7701-3(d)(1)(i).

[837] In some cases Federal tax law will treat a partnership simply as an aggregate of its members' interests and activities, while in other situations, it will regard it as an entity. For example, a US partnership which holds shares in a non-US corporation can itself be a "10% US shareholder" in that corporation when deciding if the latter is within the US controlled foreign corporation rules ("Subpart F"). That partnership can still be a "10% US shareholder" even if its partners are not US persons at all or they include US persons with less than a 10% partnership share on a "lookthrough" basis. However, the entity theory only goes so far: the US partnership itself is not subject to US tax on a Subpart F inclusion. Only its US-taxpaying partners are. This approach does not apply to non-US partnerships. This gives scope for sidestepping Subpart F by using a non-US partnership. The rules in this area are being modified in a manner which may assist US taxpayers, not least because of differences between GILTI and Subpart F: see Sullivan & Cromwell LLP: "Treasury and IRS Release Final and

single-member entity basically is: the single member is regarded, for most tax purposes, as directly owning the assets, and assuming the liabilities of that entity[838]. This is quite radical structural "tax transparency". It does not just provide[839] that the entity's profits are to be taxed solely at member level, as they arise and by reference to that member's fiscal characteristics. In particular, the "disregard" can affect parties other than the single member and the "disregarded" entity. For example, if the single member of a disregarded non-US entity is a US corporation and the disregarded entity owns another US corporation, the two US corporations can form a "consolidated group" for US tax purposes……precisely because the intermediate non-US entity is disregarded.

The 1997 rules often build on features existing pre-1997. The elective regime for "eligible entities" was a deliberate decision to make more readily accessible the benefit of similar rules which were already giving taxpayers considerable choice over US tax classification.

Pre-1997, there were also business entities which were corporations per se, although there was no equivalent of the current "per se" list for non-US entities. Pre-1997, it was also increasingly possible for many other business entities (US ones, such as LLCs, and non-US ones) to secure partnership treatment for US tax purposes if they **failed** to meet two out of four prescribed corporate characteristics. The four characteristics were fairly formalistic and each had equal weight. They were, famously, (i) limited liability (i.e. no member was liable without limit for the debts of the entity); (ii) free transferability of members' interests (i.e. substantially all of the ownership interests – meaning **all** legal rights in the entity of the owner - were transferable without the consent of the other members); (iii) centralised management (i.e. the entity was managed by one or more persons similar to a board of directors, and not by the members themselves) and (iv) continuity of life (i.e. the entity's existence did not end because of the resignation, bankruptcy, etc of any member) . The four factors were set out in the then Treasury Regulations[840] which distilled several decisions in which the US courts had

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Proposed Regulations on the GILTI and Subpart F Treatment of Domestic Partnerships". 24 June 2019. www.sullcrom.com. GILTI is discussed in 7.2.6.2.3.

[838] The single-member entity may not be a "nothing" as regards obligations to collect third-party tax liabilities e.g. it must operate employee payroll withholding.

[839] As is the case with a partnership.

[840] The so-called "Kintner Regulations": Treasury Decision 6503: Treas. Reg. 301.7701-1 to -11 (1960). These were a legislative response to *Morrissey v Commissioner* (1935) 296 US 344 and especially *United States v Kintner* 216 F. 2d 418 (9th Circuit 1954). Technically, the "Kintner Regulations" set out six factors but the first two ("associates" and "an objective to carry on a business and divide the gains therefrom") were common to all "business entities". These two factors were mainly relevant in deciding whether an entity was a "business entity" or a trust. Furthermore, the "Kintner Regulations" did not adopt a further factor mentioned in *Morrissey v Commissioner:* namely, the ability of the entity to hold title to property, no doubt because almost all entities (including partnerships) in the US can own property in their own name i.e. they have legal personality. For a recent UK discussion of the pre-1997 US entity classification regime (and especially the "continuity of life" factor), see Montagu: *Anson and Entity Classification Revisited* op. cit., in particular at pages 471-6. Interestingly, the factors set out in the "Kintner Regulations" live on elsewhere. In particular, Germany has adopted these factors for the purposes of classifying non-German entities only and has added four further factors of its own: whether a formal resolution by the entity's members is needed to distribute profits; whether entity members must make capital contributions; whether profit allocation is based strictly on member's capital contributions; and whether creating the entity requires a formal registration process. In Germany, "continuity of life" is a lesser factor and is (sensibly) applied on the basis of whether an entity can in practice (rather than theory) be dissolved when a specified contingency occurs. For further detail on the German rules, see Dr Wolf Wassermeyer: "Tax Classification of Foreign Legal Entities ('Comparability Test')" at page 1 of "Flick Gocke Schaumburg: Cross-Border Investments with Germany - Tax, Legal and Accounting – In honour of Detlev J. Piltz". Verlag Dr Otto Schmidt KG (2014).

developed the four factors. No one factor was decisive, not even continuity of life[841]. Separate legal personality was not a factor at all: almost all US partnership vehicles have legal personality anyway so the presence or absence of legal personality could not sensibly be a differentiating factor. For historic reasons, three out of four factors had to be present to achieve corporation status[842]. An entity seeking partnership status therefore had to lack at least two factors. For example, a UK unlimited liability company achieved partnership status for US tax purposes by limiting the transferability of its shares. In short, it lacked limited liability and free transferability of its members' interests.

Well-advised and well-resourced taxpayers could therefore structure entities so as to give themselves effective choice pre-1997 over the US tax characterisation of those entities. This gave them an unfair advantage, especially in relation to non-US "eligible entities"[843]. The simpler, more explicitly elective rules adopted in 1997 made such choice available to the many, not the few, even though that choice had existed for some pre-1997. It also created simplicity and certainty for taxpayers, as well as being simpler and less resource-intensive for the IRS to administer.

Furthermore, when introducing the new regime in 1997, the US Treasury highlighted another reason for turning its back on the "four factor" test which focussed on structural features of business entities and whether they "resembled" a partnership or a corporation. As it noted, "many states have revised their statutes to provide that partnerships and other unincorporated organisations may possess characteristics that traditionally have been associated with corporations, thereby narrowing considerably the traditional distinctions between corporations and partnerships under local law [emphasis added]"[844]. This narrowing has not been confined to the USA. By introducing the UK LLP, the UK has travelled the same route, although in a slightly different way.

The new rules of course made clear that a single-member entity could be disregarded, and treated for US tax purposes as a branch/sole proprietorship of the single member. Even this more radical change was based to some extent on pre-1997 authority[845].

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[841] The decision to avoid a single conclusive criterion was sensible, given the wide range of legal systems regulating business entities, both within and outside the US. In any case, as one commentator has pointed out: "continuity of life had long since been reduced to a formalism, as most state laws allow the remaining partners to reconstitute the partnership and continue in existence as though nothing had happened": Kimberly Blanchard: "The Significance of Legal Personality for US Tax Purposes": Business Entities March/April 2016 page 5 at page 11 (hereafter "Blanchard: Significance").

[842] It was made harder to achieve corporation status because, inter alia, in 1960, corporations enjoyed certain tax advantages, such as lower tax rates than individuals and the opportunity to set up a qualified pension plan.

[843] In relation to such entities, a detailed understanding of the relevant non-US law governing the entity would be necessary. In order to achieve that, detailed local law advice would of course be required and often a language barrier had to be dealt with.

[844] US Treasury, 26 CFR Pt 301 [PS-43-95] RIN 1545-AT91 "Simplification of Entity Classification Rules", cited in Montagu op. cit. at page 475. As one recent commentator has put it: "US tax law, having seen the writing on the wall, has abandoned any conceit that limited liability matters to entity classification for tax purposes, given the reality that almost any type of US entity can today afford almost complete protection from liability": Blanchard: Significance op. cit. at page 8. Blanchard goes on to describe how, under current US partnership law (in particular, Section 303 of the 2001 Uniform Limited Partnership Act), all partners in a US limited liability partnership or a limited liability limited partnership "benefit from a full, status-based liability shield…." This is not confined to liability arising from the bad acts of other partners. It also applies to debts arising in the ordinary course of partnership business. Delaware is a prime example of a state providing such a full-shield limitation, other than for liability arising from a partner's own negligence.

[845] See Michael L. Schler. "Initial Thoughts on the Proposed 'Check The Box' Regulations'. May 1996 unpublished paper for the New York Tax Club at page 15.

7.2.6.2 Lessons from the US experiment

7.2.6.2.1 How much US tax has been avoided?

As anticipated very early on, the elective regime for “eligible entities” has been widely used in US tax planning, especially cross-border planning. The US Treasury has from time to time introduced rule changes to combat less welcome side-effects of increased planning based on entity classification.

It has been heavily debated[846] to what extent the new regime has led in practice to significant additional US tax avoidance, given the ability to “de facto” choose entity classification under the pre-1997 rules. Of course one effect of the new rules is to enable a wider variety of taxpayers to take advantage of the entity classification choices which were previously available in practice only to well-advised and well-resourced taxpayers. So for that reason alone, the revised rules have probably facilitated avoidance. Furthermore, the post-1996 regime clearly allows a single-member “eligible entity” to be disregarded. Hence the use of disregarded entities in US tax planning has proliferated, especially where planning relates to the US “controlled foreign corporation” rules in Subpart F and to the foreign tax credit rules.

It is useful to consider for these purposes the US Federal tax treatment of a non-US person investing in the US via a partnership rather than a corporation (although for reasons given below, investment in the US directly via a partnership is in practice unlikely).

An inbound investor into the US which elects to invest via a US LLC, treated as a partnership, rather than a US corporation, will be fully taxable in the US on the net “effectively connected income” (distributed or undistributed) which it derives by carrying on a US trade or business via the LLC. So investing via the LLC, rather than a US corporation, does not remove the investor's US tax liability. If the investor is a corporation by US standards, it will be taxed at regular US corporate income tax rates on the net income from its US trade or business. If it is an individual, it will be taxed at progressive US personal income tax rates on that net income. Furthermore, in certain cases involving non-US corporate investors, the US branch tax will apply[847]. Where it applies, it will offset (at least in part) any saving of US dividend withholding tax which a non-US corporate investor might otherwise achieve by investing in the US through a branch or a transparent entity, rather than through a US corporation. However, if treaty relief is taken into account, the rate of any branch tax on an investment in a LLC may well be lower than the rate of US dividend withholding tax on a shareholding of equivalent relative size in a US corporation. This is especially true if the investor is a partner with a minority interest in a LLC (rather than being an equivalent minority shareholder in a US corporation)[848].

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[846] See Field op. cit. at pages 486-495.

[847] This is an additional tax charge of up to 30% under Section 884 Internal Revenue Code, where a non-US person invests in the US via a branch. It taxes a so-called “dividend equivalent amount” i.e. the after-tax amount of certain US-taxable income of the branch which is not treated as reinvested in a US trade or business. There are of course no actual dividends because a branch, unlike a subsidiary, does not pay dividends. It is US tax policy to amend the “Non-Discrimination” Article in its treaties so as to protect its right to impose the branch tax: see for example Article 25(6) of the 2001 UK-US treaty.

[848] US dividend withholding tax on, say, a less-than-10% shareholding in a US corporation will probably not be less than 15%, even with the benefit of treaty relief. By contrast, if the investor has a less-than-10% interest in a US partnership, that interest by itself will be regarded as the **separate** US branch of that particular investor. Hence the branch tax may well be 5% or less, after treaty relief. Those lower branch tax rates under treaties

A sale of shares by a non-US investor in a US corporation will not normally give rise to US tax on any gain[849]. The same is not true of a sale by a non-US partner of an interest in a US LLC taxed as a partnership. In 2017, the United States Tax Court in *Grecian Magnesite Mining*[850] decided that a sale by a non-US investor of an interest in a US LLC (taxed as a partnership) did not automatically amount to a disposal of a corresponding share of each of the underlying assets of the LLC. The same result would not have been reached if the investor had been the sole member of a US LLC which was simply disregarded, rather than treated as a partnership. This decision highlights how for US tax purposes, a partnership (unlike a disregarded entity) is not a tax "nothing". Indeed, in some situations, it will be treated as an entity, while in others, it will be regarded as an aggregate of its members.

The IRS unsuccessfully appealed the Tax Court's decision[851]. However, the US Tax Cuts and Jobs Act 2017 has reversed the effect of *Grecian Magnesite Mining* for future years[852]. An equivalent effect can still be secured if the non-US investor indirectly invests in the US LLC through a US "blocker" corporation. This is typically a purpose-formed corporation (by US standards) whose sole asset would be the LLC interest. The non-US investor would then exit by selling an interest in the "blocker", rather than selling directly the underlying LLC interest. There are other benefits anyway from using a US "blocker" in this way. In particular, the non-US investor need not file a US tax return and branch tax is avoided[853].

Hence, one should not overstate the tax difference between investing in the US via a US LLC treated as a partnership, rather than via a US corporation. Aside from the fact that direct investment into the US via a partnership is rare, each case will be fact-sensitive. In this regard, an important recent

correspond to the lower rates of US dividend withholding tax which would be permitted under a treaty if that corporate investor had a substantial non-portfolio shareholding, rather than a less-than-10% shareholding, in a US corporation.

849 Unless the US corporation is US real estate-"rich": a US Real Property Holding Corporation.

850 See fn 487.

851 See fn 487.

852 The 2017 Act in effect codifies Revenue Ruling 91-32 (which the Tax Court and the US Court of Appeals (Washington, D.C. Circuit) declined to follow) in a new Section 864(c)(8) Internal Revenue Code 1986 (as amended). Proposed Treasury Regulations were issued in December 2018 to flesh out Section 864(c)(8). A new Section 1446(f) Internal Revenue Code 1986 (as amended) imposes a 10% withholding obligation on a transferee of a partnership interest, reinforcing Section 864(c)(8). Gain or loss from the sale or exchange of a partnership interest by a non-US partner will henceforth be US-taxable "effectively connected income", to the extent that the non-US investor would have had effectively connected income or loss if the partnership had sold all of its underlying assets for cash at fair market value when the sale or exchange of the partnership interest took place. In short, Section 864(c)(8) does not treat the partnership interest as a separate "indivisible capital asset" but looks through to the underlying partnership assets. Where applicable, these new rules supersede existing rules which treat a sale or exchange of a partnership interest as triggering "effectively connected" income to the extent of the partnership's underlying US real property assets. For a discussion of Section 864(c)(8) and the Proposed Regulations, see "Treasury adds color to *Grecian* Repeal – Proposed Regulations implement new Section 864(c)(8) for Sale of Partnership Interests by Foreign Partners": Legal Update dated 8 January 2019 at www.mayerbrown.com. (accessed 6 July 2020). A further set of Proposed Regulations was published in 2019 clarifying how withholding under the new Section 1446(f) will apply. This will depend on whether or not an interest in a "publicly-traded" partnership is being transferred: see "IRS Issues Proposed Regulations regarding Withholding under Section 1446(f)": Legal Update dated 6 June 2019 at www.mayerbrown.com. (accessed 6 July 2020).

853 See Kimberly S. Blanchard: "What is the Government's Appeal in 'Grecian' About?" Tax Management International Journal. Vol. 47, No 8, page 546. 10 August 2018.

development is the reduction to 21% (from 35%) of the headline Federal corporate income tax rate for US corporations in the Tax Cuts and Jobs Act 2017[854]. For a US individual investing in a US corporation, the new rate means that the effective tax rate on distributed corporate profits is 36.8% (21% at the level of the corporation with a further 20%, in most cases, on the after-tax profits of the corporation, but only if they are distributed)[855]. This compares with a maximum 37%[856] if the same underlying income is earned through a US partnership (in which case it will be taxed at that rate whether or not distributed)[857].

If the US corporation or partnership in turn owns an interest in an entity which is a controlled foreign corporation for US tax purposes, then the individual would be well-advised to invest in a US corporation rather than a US partnership, in order to avoid penal tax effects described in 7.2.6.2.3-4.

7.2.6.2.2 Use of "check-the-box" elections as part of cross-border tax planning by multinationals

Much "check-the-box" tax planning has historically occurred when US taxpayers invest outside the US. A key objective has been to minimise the extent to which profits from the US taxpayer's non-US operations were subject to US tax before being physically repatriated to the US, under the various US anti-deferral regimes (and especially "Subpart F", the US controlled foreign corporation rules). Where applicable, Subpart F taxes undistributed profit of a "controlled foreign corporation" at regular US corporate income tax rates in the hands of certain US persons with an interest in that corporation ("10% US shareholders)[858]. Taxpayers often made elections to disregard single-member non-US affiliates which were directly owned by a single non-US subholding entity, while a separate election was made to treat the latter as a corporation for US tax purposes. This structure effectively treated those disregarded affiliates as branches of the non-US subholding entity. Hence income flows (especially interest, dividends and royalties) from those lower-tier affiliates, to that subholding entity, would be disregarded for Subpart F purposes.

There was de facto acceptance of this avoidance of Subpart F by the US tax authorities. Before the 2017 Act, US multinationals long complained that the high headline US corporate income tax rate (35%), coupled with Subpart F, eroded their ability to compete with more favourably taxed non-US competitors. "Check-the-box" planning of the kind described above reduced the impact of Subpart F on non-repatriated earnings from outside the US. Hence it was a self-help solution to the concerns

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[854] The formal title of this Act is "An Act to provide for reconciliation pursuant to Titles II and V of the concurrent resolution on the budget for fiscal year 2018, H.R. 1, 115th Congress (2017)". The reduction in the headline corporate income tax rate is accompanied by important tax base-widening measures: in particular, a cap on the overall amount of deductible interest, and extensions to the controlled foreign corporation rules (notably GILTI – see 7.2.6.2.3 below). These base-widening measures can also apply to individual taxpayers. Overall they may well push the effective tax rate above the new headline rate.

[855] If the investor were non-US, that 20% tax rate on distributions would rise to 30%, subject to treaty relief. There could also be tax on that distribution in the investor's home jurisdiction.

[856] In some cases, the rate in respect of distributed and undistributed income earned through a partnership can be reduced to 29.6% because of the Pass-Thru Deduction. However, this is not available in respect of income from partnerships providing law or accounting services, or engaging in investing or financial trading. Furthermore, the Pass-Thru Deduction is scheduled to end after 2025.

[857] If the investor were non-US, one would also have to take into account "branch tax" (up to 30%, subject to treaty relief) as well as any tax in the investor's home jurisdiction, presumably with some relief for US tax.

[858] Subpart F applies in particular to "passive" income of a controlled foreign corporation (or, to give it its more precise title, "foreign personal holding company" income).

raised by US multinationals. It led to them accumulating low-taxed cash in offshore subsidiaries which were "controlled foreign corporations".

Furthermore, this structuring created significant opportunities for eroding the non-US tax liabilities of the lower-tier non-US affiliates which were directly owned by the non-US subholding entity. This would be achieved by those affiliates making deductible interest and royalty payments to low-taxed affiliates not resident in the home jurisdiction of the payer. Those payments would likely be disregarded for US purposes for the reasons given above. However, they would usually be respected as deductible payments in the home jurisdictions of the payers, where those affiliates would be taxable entities. Hence, a valuable tax mismatch would be created with expense being deducted for non-US tax purposes without giving rise to a corresponding US income inclusion as long as no cash was repatriated to the US. This mismatch relied on the difference between the US "disregarded" entity analysis and the way in which the same intra-group transaction was analysed in the home jurisdictions of the lower-tier affiliates.

"Check-the-box" planning has also been used extensively in structures for inbound investment into the US. For example, in the early 2000's, UK multinational parent companies used "deferred share subscription" structures to fund their US subsidiaries in return for periodic capital contributions into a special-purpose UK subsidiary of the UK parent company. Economically, these structures were amortising loans to the US subsidiary. However, no interest income was recognised by the UK parent because the periodic capital contribution payments by the US subsidiary were regarded as deferred subscriptions for share capital in the special-purpose UK subsidiary. These were not subject to UK tax in the UK subsidiary. In particular, they were not treated as interest and principal repayments on a loan. From a US tax perspective, the structure was treated as a loan to the US subsidiary by the UK parent because an election would be made to disregard the special-purpose UK subsidiary for US tax purposes. Hence the periodic payments were treated as direct interest payments and principal repayments by the US subsidiary to the UK parent. The interest component of those payments was deductible for US tax purposes[859], even though it was not recognised as income for UK tax purposes.

This last example illustrates a most important point. The divergence between the approach of the post-1996 US entity classification rules and those of other jurisdictions is key. In particular, it gives extra scope for generating cross-border tax mismatches[860]. A taxpayer which wants to create an "eligible entity" classification mismatch between the US and another jurisdiction can readily do so by (i) altering structural features of the relevant entity to achieve the desired non-US classification; while

[859] The UK legislated to ensure that the interest element of these structures became taxable in the UK: see Section 91A Finance Act 1996, re-enacted as Section 524 CTA 2009 and now replaced by the "disguised interest" rules in Part 6 Chapter 2A CTA 2009. See also Sections 249 to 254 (now repealed) TIOPA.

[860] For an alternative viewpoint, see Blanchard: Significance op. cit. at page 53. That commentator states that the BEPS project and others have exaggerated the extent to which the "check-the-box" rules have created hybrid mismatches and have underestimated "the larger cause of entity hybridity, which is a natural feature of the divergence of law in different countries. One source of hybridity is the tendency of many countries to apply per se rules or comparability tests to classify foreign entities, and to use concepts, like legal personality, that are essentially meaningless in the other country. If countries are going to insist on this relatively arid exercise, the rule should at least take into account substance rather than empty legal forms". This author certainly agrees that, when considering hybrid mismatches, treating the "check-the-box" rules as the root of all evil is an oversimplification. Not least it ignores the deficiencies of other countries' entity classification rules, notably those of the UK. However, the point made in the main text about the nature of the post-1996 US rules remains key.

(ii) simply electing to achieve the desired (and contrasting) US classification. In the US, classification no longer hinges significantly on an entity having the "right" structural features. Hence a taxpayer can structure an entity to achieve the desired non-US tax classification, without worrying whether its structural features achieve the desired US tax classification[861].

7.2.6.2.3 Further effects of the 2017 US tax reforms

The Tax Cuts and Jobs Act 2017 is the most significant US tax reform since 1986 and has a significant impact on US tax planning, both as regards investment into and out of the US[862]. The comments below focus on investment out of the US. In addition to reducing the corporate income tax rate to 21%, hitherto unrepatriated non-US earnings of non-US subsidiaries were taxed on a "one-off" basis in the hands of US shareholders holding (or treated as holding) at least 10% of the relevant subsidiary[863]. There is a new exemption, in Section 245A Internal Revenue Code, for non-US dividends received by US **corporate** shareholders[864] with actual or deemed equity interests of at least 10% in the distributing non-US corporation ("**10% US shareholders**")[865]. However, the ability to use this exemption to repatriate otherwise untaxed profit from, in particular, a "controlled foreign corporation" is not the end of the story. There is also a new charge on such 10% US shareholders in respect of "global intangible low tax income" (or "GILTI") of that "controlled foreign corporation"[866].

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[861] Reconciling US and non-US rules pre-1997 would have been harder because the then US entity classification rules also focussed on structural features of the relevant entity, as discussed at 7.2.6.1.

[862] This Act is quite recent and passed very rapidly through Congress. The result was a large number of legislative loose ends and uncertainties, which are gradually being resolved with the benefit of administrative guidance and, possibly, further legislation. The discussion of the Act in this Chapter is largely based on (i) www.davispolk.com/Resources/Blogs/Tax Reform and Transition/In-Depth Analysis of TCJA (accessed 6 July 2020); and (ii) www.clearygottlieb.com/News & Insights/Publications/ Tax Cuts and Jobs Act: Our Insights February 21, 2018. (seemingly no longer readily accessible).

[863] The tax charge was levied before the end of 2018 at rates ranging between 8% and 15.5%. This rate increased dramatically if the US shareholder taxpayer later engaged in an "inversion" transaction. The "one-off" tax could be paid in eight equal annual interest-free instalments. Furthermore, if the US shareholder was a S Corporation (but not a partnership), it could defer this tax charge further on generous terms.

[864] S Corporations and partnerships cannot claim the benefit of this exemption, nor can Regulated Investment Companies nor Real Estate Investment Trusts. However, there is a "look-through" rule permitting a regular US corporation, which is a partner in a partnership, to claim the exemption in respect of its share of a non-US dividend paid to the partnership (cf the French decision in *Artemis* – see 6.5.1). The Section 245A exemption does not apply to Subpart F inclusions nor to any dividend which gives rise to a deduction or other tax benefit outside the US. The company paying the dividend must also not be a "passive foreign investment corporation" ("PFIC"). Last but not least, this exemption only applies to dividends and not to capital gains on disposing of the relevant shares, unless that gain is treated, in limited cases, as a dividend under Section 1248 Internal Revenue Code.

[865] The US corporate shareholder must meet a minimum one-year holding period to qualify for the exemption. In October 2018, Proposed Regulations were issued which, if finalised, will create a parallel exemption from the US tax charge under Section 956 Internal Revenue Code, which otherwise applies when income of a "controlled foreign corporation" is invested in "US property" (e.g. debt or equity of a US person affiliated with the "controlled foreign corporation"). For more information, see Sullivan & Cromwell LLP: "IRS Issues Proposed Regulations on Section 956". 31 October 2018. www.sullcrom.com. (accessed 6 July 2020).

[866] The GILTI charge does not just apply to 10% US Shareholders which are corporations. It also applies to any such shareholders who are individuals, in which case the GILTI rules are much harsher. The individual 10% US shareholder is subject to the GILTI charge at regular progressive tax rates for individuals (now up to 37%). Unlike corporate shareholders, it does not benefit from a special deduction which reduces the effective GILTI tax rate to 10.25% until 2025 (and thereafter to 13.125%). Furthermore, only corporate 10% US shareholders can claim a US foreign tax credit for non-US tax on the income subject to GILTI. That foreign tax credit is capped

This GILTI charge applies to distributed or undistributed income. It is not confined to intangibles income, despite its name, and is in fact imposed on the "controlled foreign corporation"'s total net income in excess of 10% of its aggregate tax basis in its **tangible, depreciable** property (less any relevant net interest expense)[867]. In short, GILTI is a new, wide-ranging US tax charge on outbound investment.

It is unlikely that the GILTI charge can be avoided by making the "disregarded entity" elections which have been used in the past to accumulate low-taxed income outside the US without triggering Subpart F. Indeed the Tax Cuts and Jobs Act 2017 seeks to get away from a situation where US companies accumulate low-taxed cash outside the USA, as a self-help solution to excessively high domestic rates of corporate income tax. Nevertheless, the GILTI charge is in addition to, not a replacement for, the existing Subpart F rules. Managing existing Subpart F exposure in a manner which minimises relevant non-US taxes will therefore remain important, especially as the tax rate on GILTI for corporate taxpayers is significantly less than for Subpart F inclusions (which are taxed at regular US corporate income tax rates…..now 21%). Hence "disregarded entity" planning may have enduring relevance in managing Subpart F exposure apart from GILTI[868].

Generally, managing non-US taxes of a US multinational group will become even more important for two reasons. The new dividend exemption in respect of non-US dividends means that any non-US tax on non-US distributed profits (e.g. withholding tax) is an absolute cost. Besides, at most 80% of any non-US tax on GILTI income can be credited in the US and in practice it may well be difficult to credit even that much[869]. Therefore there is an extra incentive to reduce that non-US tax burden.

7.2.6.2.4 Entity classification decisions in the light of the 2017 changes

Features of the 2017 Act itself are likely to drive other tax-planning responses, which may require specific decisions on US entity classification.

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at 80% of the relevant non-US tax and there is a separate GILTI "basket" when applying the US foreign tax credit limitation. That separate "basket" in particular makes it harder to use excess foreign tax credits relating to GILTI.

867 That tax basis will be computed on US tax principles. As it relates only to **tangible** depreciable property, it is likely to exclude real estate. It is also easy for large amounts of GILTI to arise if the controlled foreign corporation has valuable intangibles and/or fully-depreciated tangibles. This is often the case in the kind of outbound investment structures which have been deployed by the US technology companies: valuable intangibles will be localised in low-taxed non-US subsidiaries. They then licence those intangibles (for tax-deductible royalties) to related operating subsidiaries in other high-tax jurisdictions. The rules for deducting interest when computing GILTI are complex and may well reduce the benefit of the 10% offset relating to tangible depreciable property: see Sullivan & Cromwell LLP: "Treasury and IRS Release Final Regulations on Global Intangible Low-Taxed Income Regime" 8 July 2019. www.sullcrom.com. (accessed 6 July 2020).

868 The GILTI rules differ in important respects from Subpart F. Broadly speaking, Congress intended the tax burden in respect of GILTI to be less than that in respect of Subpart F income, at least in relation to 10% US shareholders which are corporations. However, there may be situations where it makes sense to structure so that income falls within Subpart F or the "high tax" exclusion from Subpart F, rather than GILTI, thereby achieving a lower tax burden: see Libin Zhang "To the Frying Pan: New Virtues of Subpart F Income over GILTI", Tax Notes, 2nd July 2018 at page 73. See also Sullivan & Cromwell LLP: "Treasury and IRS Release Regulations on the GILTI High Tax Exclusion": 1 July 2019. www.sullcrom.com. (accessed 6 July 2020).

869 For the complexities of computing the revised US foreign tax credit in respect of GILTI, see Sullivan & Cromwell LLP: "Proposed Foreign Tax Credit Regulations". 11 February 2019. www.sullcrom.com. (accessed 6 July 2020).

In particular, the GILTI charge on a non-corporate US shareholder in a controlled foreign corporation is very high (although there is some scope for an individual US shareholder to elect to be taxed at corporate rates under Section 962 Internal Revenue Code). Hence, a non-corporate US shareholder shareholder may want its interest in the controlled foreign corporation to be held through an entity which is a domestic corporation for US tax purposes.

If, on the other hand, that shareholder is determined to own directly its interest in a non-US business, then it may want to reclassify any controlled foreign corporation in which it invests as a partnership or disregarded entity for US tax purposes. Any tax costs of that reclassification must of course be evaluated[870]. Assuming they are acceptable, owning through a partnership or disregarded entity will give that US person greater scope for using losses, claiming capital gains treatment and obtaining foreign tax credit relief. It will avoid GILTI (and Subpart F in general) although it will be currently taxable in the US on its share of the income and capital gains of the partnership or disregarded entity, whether or not distributed.

While the US has created a dividend exemption for certain non-US dividends paid to a US corporation, it has not been decided whether a controlled foreign corporation can also rely on this exemption when computing its own Subpart F income or GILTI, if it receives a dividend from a lower-tier non-US subsidiary[871]. Hence, it may make sense to elect to disregard that lower-tier subsidiary. In that case, the question whether the dividend exemption is available for the purposes of the Subpart F or GILTI computation does not arise.

The 2017 Act offers accelerated depreciation rates for certain new and used tangibles until 2026. With this in mind, US purchasers of companies during this period may wish to turn them into partnerships or disregarded entities so as to access accelerated depreciation in respect of the underlying assets[872].

Whether an entity is a partnership or a disregarded entity may also be relevant in relation to the new Section 163(j) Internal Revenue Code. This introduces an overall cap on deductible interest expense for all US taxpayers. This is set at 30% of “adjusted taxable income”, which is initially defined as EBITDA but in later years as EBIT[873]. Either way, the US taxpayer will be able to take into account its interest in the income of a non-US partnership or disregarded entity when computing “adjusted taxable income”. That increases its “adjusted taxable income” and thereby limits the impact of Section 163(j).

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[870] E.g. tax on any deemed liquidation of the “controlled foreign corporation”.

[871] See Sullivan & Cromwell LLP: “Treasury and IRS Release Temporary Regulations Limiting Section 245A Dividends Received Deduction”, page 6 at fn 8. 28 June 2019. www.sullcrom.com. (accessed 6 July 2020).

[872] This will of course need to be agreed with the seller although if the latter is non-US, there may well be no adverse consequences for the seller. The same depreciation result could be achieved by making a Section 338(h)(10) or 338(g) election in the US. These elections are not part of the US entity classification rules but in some cases, permit a share sale to be treated as a sale of the relevant company’s underlying assets.

[873] This is less generous than the equivalent UK rules introduced in 2017 in response to the conclusions of BEPS Action 4. The US rules also do not give the option of applying a separate interest cap based on worldwide leverage of the US taxpayer’s group. In other respects, the US rules are more generous than those in the UK e.g. there is a narrower definition of “interest” and a more generous exclusion for smaller businesses. For more information, see Mark Saunderson and Miles Humphrey: “Analysis – US Tax Reform: practical aspects”. Tax Journal, Issue 1403, page 14. 15 June 2018.

7.2.6.2.5 Final thoughts on the US entity classification rules

While significant tax planning has been based on the US entity classification rules introduced in 1997, not all of that planning should be seen as abusive. In any case, those rules illustrate some broader points. In particular, the US has recognised that classifying entities for tax purposes by reference to non-tax structural features is an increasingly flawed and arbitrary approach, especially when the structural and other substantive differences between a corporation and a partnership have been so greatly eroded. The old approach is also a poor use of both taxpayer and IRS time and resources.

A key underlying issue is that, although the non-tax differences between corporations and partnerships are increasingly insignificant, the Internal Revenue Code nevertheless distinguishes between them and taxes them very differently. US corporations and their members are subject to two levels of taxation under Subchapter C[874] of the Internal Revenue Code: once at entity level on all their profits and then again at member level, on distributed profits. There is very limited relief against the tax at member level for US or non-US tax borne at entity level. By contrast, under Subchapter K, partnerships are subject to a single US tax charge on their profits (whether or not distributed) but calculated by reference to the tax position of the members of the partnership. Relief for non-US tax on those profits is more readily available. In short, the partnership is tax-"transparent".

The contrast between Subchapter C and Subchapter K is an old and largely immutable feature of the US tax system. Any mandatory line drawn between entities to determine which Subchapter governs is likely to be arbitrary[875]. The ability to elect classification gives the taxpayer some simple leeway to avoid an arbitrary outcome being imposed on it. That leeway is not total, because of those rules which make certain US and non-US entities corporations "per se". The rules on "per se" corporations are often hard to justify but are likely to endure. Otherwise the scope of Subchapter C taxation would shrink to an unacceptable degree politically and would thereby undermine taxpayers' limited right to elect entity classification. In short, for US taxpayers, the status quo is a case of half a loaf being much better than no bread.

From the perspective of the US Government, any avoidance issues raised by elective entity classification are probably better dealt with by tackling those specific issues (e.g. erosion of Subpart F) rather than by denying taxpayers their limited right to elect. The fact that an entity falls within Subchapter K (or is disregarded) does not prevent the US from limiting consequences which might otherwise flow automatically from a "transparent" approach. Indeed, given the minimal non-tax differences between corporations and partnerships, this may be the better policy response. Of course counteracting specific avoidance issues will further complicate the US tax code, which to some extent nullifies the simplification benefits of the 1997 changes. However, even before those changes, Subchapter K and the Subpart F rules were very complex.

7.3 *The Dutch entity classification rules*

7.3.1 *Introduction*

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[874] There is of course an exception for those smaller US corporations which elect for "pass-through" taxation under Subchapter S.
[875] This is true, for example, of the US default classification rules in respect of "eligible entities" e.g. their focus on limited or unlimited liability in relation to non-US entities.

As a civil law jurisdiction with its own distinct views on aspects of entity classification and its impact on double tax treaties[876], the Netherlands offers an interesting contrast to both the UK and the US approach to entity classification.

7.3.2 *Classification of domestic Dutch entities*

Article 2(1) of the Netherlands Corporate Income Tax Act 1969[877] lists the entities that are taxable on their worldwide income if resident in the Netherlands. This list includes in particular Dutch corporate entities[878] such as public limited liability companies ('naamloze vennootschap' or NVs), private limited liability companies ('besloten vennootschap' or BVs), co-operative associations, mutual insurance organisations, as well as foundations ("Stichtingen") and other associations ("Verenigingen")[879].

However, the list of Dutch entities taxable on their worldwide income under CITA runs wider and in particular includes an "open" limited partnership ('commanditaire vennootschap" or 'CV')[880]. This is one in which limited partners can be admitted without the prior consent of all other partners[881]. An

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[876] See in particular the Dutch observations in Articles 1, 23A and 23B of the OECD Model Tax Convention. These are cited by De Graaf and Gooijer in their country report on the Netherlands in Volume 99b Cahiers de Droit Fiscal International (2014), at pages 566-7.

[877] Wet op de vennootschapsbelasting 1969 (hereafter **"CITA"**).

[878] Being a civil law jurisdiction, Dutch domestic law recognises both "formal" and "informal" partnerships, a distinction not known in common law jurisdictions. It turns largely on the extent to which, under civil law concepts of agency, the members of the partnership are sufficiently disclosed to third parties that they can incur obligations to them because of the activities of the partnership. The Dutch "formal" partnership is the "Vennootschap onder firma" or "VOF". The "informal" Dutch partnership is the "maatschap" whose members may or may not be fully disclosed to third parties. If not fully disclosed, the "maatschap" will be a form of "silent" partnership, where the "silent" partners will not incur obligations to third parties. For a more extensive discussion of the "formal"/"informal" partnership distinction, see Part II of Avery Jones: Partnerships op.cit. [2002] BTR 375. The UK Court of Appeal has in fact considered the nature of a VOF in a non-tax case, *Rowan Companies Incorporated v Lambert Eggink Offshore Transport Consultants VOF* [1998] CLC 1574. Expert evidence was taken regarding Dutch law. The court concluded that, in essence, a VOF was quite similar to a Scottish, rather than an English general partnership. In particular, while it was not a "complete" legal person like a body corporate, it could nevertheless contract, sue and be sued in its own name because it represented the partners "taken as a whole" and was not just an aggregation of individual partners. Those individual partners were jointly and severally liable for the obligations of the VOF under Article 18 of the Dutch Commercial Code.

[879] For a fuller list and general discussion, see De Graaf and Gooijer op. cit. at page 559. A co-operative does not normally have a capital divided into shares. This means that, subject to anti-avoidance rules introduced in 2012, its distributions to members are not subject to Dutch dividend withholding tax although the entity itself remains subject to Dutch corporate income tax: Michael L. Molenaars: "The Tax Significance of Legal Personality: a Dutch View" Tax Review No. 316 (December 2014) at 2.2.3. "Stichtingen" are legal entities with no members, created for a defined purpose, often charitable. They may not distribute to their founder: see Molenaars op.cit. at 2.1(i). However, it is possible to get around the formal lack of members by the Stichting issuing depositary receipts (a so-called "Stichting administratiekantoor" or "STAK"). Each such receipt confers a proprietary interest in the underlying assets of the Stichting and, in the words of one commentator, "achieves a result that is functionally equivalent to an interest in possession trust". A STAK is therefore regarded as "transparent" for Dutch (and indeed UK) tax purposes. For further commentary on STAKs, see James Kessler QC: "Taxation of Non-Residents and Foreign Domiciliaries" op. cit. at page 4555.

[880] Apart from "open" CVs, Dutch general and limited partnerships are not regarded as separate taxable entities for CITA, although Dutch company law regards them as separate entities.

[881] For reasons other than inheritance: see Article 2(3) (c) of the 1959 Algemene wet inzake rijksbelastingen (General Taxes Act; hereafter **"GTA"**). Article 2(3)(c) contains a definition of an "open" CV - of which the most

"open" limited partnership in fact enjoys a hybrid, "part-transparent" tax status. It is a separate taxpayer under CITA in respect of the share of its profits allocable to the limited partners, but its general partners are taxable directly on their (typically small) share of those profits[882]. The general partner's profit share is deductible in computing the taxable profits of the "open" CV. Like an English limited partnership, a CV (whether "open" or "closed") is merely an agreement between its members which has no legal personality. Hence one party to the agreement will usually act as general partner, and will hold the assets of the CV and incur its liabilities[883].

It is therefore possible to alter the classification of a CV for Dutch tax purposes by amending its rules on admitting limited partners. This is controversial but is not dissimilar to the pre-1997 ability to change an entity's US tax classification by dropping or retaining certain structural features (notably, free transferability of members' interests). However, expert advice will be needed when altering the structural features of a CV so as to affect whether or not it is "open"[884].

Similar tax rules apply to Dutch mutual investment funds ("fondsen voor gemene rekening" or "FGRs"), even though such funds are typically contractual agreements, rather than legal entities or (perhaps) partnerships under Dutch company law. Hence a FGR is a separate entity for CITA if participations in it can be disposed of without the consent of all investors[885]. This is so even though legally, the assets of the FGR will be held by a separate depositary with legal personality (often a "stichting") for the risk and account of the FGR members (i.e. the investors).

If interests in a CV or a mutual fund are not freely transferable (as defined), it will be "transparent" for Dutch tax purposes. This is the usual situation and merely means that its profits will be taxable only at the level of its members, based on their specific fiscal characteristics. It does not mean that the CV or mutual fund will be "disregarded" or a fiscal "nothing".

Dutch tax law permits certain Dutch-resident companies to form a tax consolidation, or "fiscal unity", for corporate income tax purposes. This also does not lead to the members of the fiscal unity being "disregarded" for corporate income tax purposes. They remain as theoretical taxpayers, which can, for example, invoke tax treaties. However, their transactions, assets and liabilities are attributed to the parent company of the "fiscal unity", which is the sole taxpayer.

7.3.3 *Classification of non-domestic Dutch entities*[886]

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important features are described above - which applies to the CITA (and also to the personal income tax act/Wet inkomstenbelasting 2001/hereafter "ITA 2001").

[882] This hybrid "part-transparency" is a consequence of the decision of the Hoge Raad (Supreme Court) of 7 July 1982, no. 20 655, *BNB* 1982/268.

[883] See Molenaars op. cit. at 2.1(ii).

[884] For a fuller discussion of these complexities, including the 2007 "CV Decree" of the Dutch Ministry of Finance, see Molenaars op. cit. at 2.2.1.

[885] This will not be the case if participations can only be transferred back to the fund itself or to certain close relatives of the relevant investor. For further detail, including the 2007 "FGR Decree", see Molenaars op. cit. at 2.2.2.

[886] For a fuller decision, see Chapter 12 – the Netherlands, in "Hybrid Entities and the EU Direct Tax Directives" edited G.K. Fibbe and A.J.A. Stevens. Wolters Kluwer.

Dutch tax law adopts a "resemblance" approach akin to UK tax law when classifying, for Dutch tax purposes, those entities which are not formed under Dutch law[887]. In particular, it classifies them by comparing them with Dutch entities[888]. Hence it focusses on the characteristics of the non-Dutch entity, as determined under its governing law[889] and constitutional documents[890]. The entity's non-Dutch tax classification is irrelevant[891].

As in the UK, there are no hard and fast classification criteria for non-Dutch entities and case law guidance is limited. The Dutch Ministry of Finance has nevertheless published a Decree setting out relevant criteria. This Decree[892] seeks to distil relevant case law principles and is in practice very important. While it is not binding on the courts as such, a taxpayer can invoke it as a matter of administrative law because it creates a legitimate expectation of particular tax treatment. It does not apply to the classification of non-Dutch foundations, mutual funds, trusts and similar entities[893].

The Dutch Decree sets out four key factors:

1. Can the non-Dutch entity legally own the assets with which it performs its activities i.e. does it have separate legal personality ("the ownership factor")?

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[887] The basis for this is Article 2(1)(a) CITA mentioned above providing that domestic taxpayers include *inter alia,* Dutch NVs, BVs and other entities that have a capital divided into shares. The last category i.e. "other entities that have a capital divided into shares", may encompass a limited company that is incorporated under the laws of another jurisdiction. See also J.L. van de Streek*, Cursus Belastingrecht (Vennootschapsbelasting)*, (Kluwer, digital), Chapter I, para. 1.0.3.A.b3 (J.L. van der Streek & S.A.W.J. Strik eds.).

[888] It does not follow the Italian approach of treating all such entities as corporations.

[889] The governing law for these purposes will be the law of the place of the entity's incorporation or formation, rather than the law of the place of its "seat". This is consistent with the overall approach of Dutch company law to an entity's domicile.

[890] This approach is described by some scholars as the "corporate resemblance method": see for example A.J.A. Stevens, Het nieuwe classificatiebesluit, NTFR-B 2010/12, p. 7-13; A.J.A. Stevens, Hybride entiteiten en belastingverdragen, MBB 2010, no. 4, p. 135-144.

[891] Unlike for example the Danish entity classification rules, which in some cases will take into account the tax classification of an entity in another jurisdiction, so as to avoid a classification mismatch: see Parada: Article 1(2) op. cit. at pages 370-1. In a recent Report for the Dutch Association of Tax Science (Vereniging voor Belastingwetenschap), G.K. Fibbe and A.J.A. Stevens argued that the Dutch domestic law should apply the Danish approach in addition to the corporate resemblance approach. In case of a mismatch, the Netherlands would follow the other state's entity classification. Fibbe had already argued in his PhD thesis that a symmetrical approach should be enshrined in a EU Directive. See. G.K. Fibbe and A.J.A. Stevens, Internationale fiscal aspecten, Chapter 6, in: Belastingheffing van personenvennootschappen, Rapport van de Commissie Personenvennootschappen, 2020, p. 151 et seq.

[892] Decree of the State Secretary of Finance of 11 December 2009, CPP2009/519M BNB 2010/58 (Kwalificatie buitenlandse samenwerkingsverbanden). There is no formal English translation of this Decree. It supersedes and amends earlier Decrees of 1997 and 2004. In particular, the factors listed in the 2009 Decree no longer include the question whether a resolution is needed to distribute the entity's profits. This factor would be a highly relevant factor for UK entity classification purposes. Indeed it was a key point of contention in *Anson v HMRC* [2015] STC 1777 (see 2.14) and also in *Dreyfus v IRC* 14 TC 560, where the Court of Appeal (see 2.10) concluded (wrongly in the view of HMRC) that such a resolution was needed in relation to a French SNC. There is a more detailed discussion of the 1997 Decree in Avery Jones: Partnerships op. cit. at pages 415-9. In fn 200 of that article, a 1995 decision of the Court of Appeal of Amsterdam of 4 February 1995, no. 93/1466, Infobulletin 1995/315, in which the Dutch court concluded that a French SNC was transparent for Dutch tax purposes i.e. the opposite conclusion to the English courts in *Dreyfus* but in line with what HMRC now regard as the correct answer.

[893] See para. 3.4 of the Decree.

2. Do all members of the entity enjoy limited liability for its obligations to third parties ("the liability factor")?
3. Does the entity have the equivalent of share capital ("the share factor")?; and
4. Can new members be admitted without the consent of all other members (ignoring cases where a member's interest passes by inheritance) ("the free transferability factor")?

Echoing the pre-1997 US entity classification rules, the Decree considers the non-Dutch entity to be non-transparent only if the answer to at last three of the four questions is "yes". This at-least-three-out-of-four approach is also more mechanistic than the approach adopted by HMRC following *Memec*[894]. Unlike the pre-1997 US rules, the Dutch rules places some emphasis on whether there is legal personality[895]. They do not place any emphasis on whether management is centralised nor on whether the entity has a limited life.

The Decree also states that a non-Dutch entity is non-"transparent" if members' liability is limited to their agreed capital contributions; the entity itself own its business operation; and that business is not otherwise operated at the risk of, or on behalf of the entity members[896]. This separate rule apparently cuts across the four-factor approach mentioned above[897]. However, on the basis of the 2009 Decree, a US LLC can still in theory be "transparent" for Dutch tax purposes if its members' interests do not take the form of share capital (as in *Anson* – see 2.14); and can only be transferred with the consent of the other members.

The Decree also provides that an entity which would prima facie be "transparent" (on the basis of the four factor test) is nevertheless non-"transparent" if it is comparable to a Dutch "open" CV or if its capital is divided into freely transferable shares. As discussed at 7.3.2, what makes an "open" CV non-"transparent" for Dutch tax purposes is the free transferability of members' interests. Where that feature is present, then the non-Dutch entity will be comparable to a Dutch "open" CV if it carries on business; there is at least one general partner with unlimited liability, as well as at least one limited

[894][1998] STC 754. The list of entity classification criteria produced by HMRC following *Memec* does not mandate a particular classification outcome if certain criteria are satisfied. All listed criteria are potentially relevant although some are more important than others. See 2.13 and 3.7.

[895] This is a point of similarity with the UK approach. However, as pointed out in Blanchard op. cit., legal personality is not a relevant criterion for US entity classification purposes. Hence any focus on it by the UK or the Netherlands in relation to US entities raises the risk of a classification mismatch. Strictly speaking, the Dutch emphasis is on whether a non-Dutch entity is a capital company or a partnership. Hence, a general partnership with legal personality formed under the law of one of the States of the US can be regarded as transparent, because it resembles a Dutch general partnership (a VOF). In particular, its partnership characteristics are more relevant than its legal personality. The distinction between partnerships and capital companies is not always clear as is demonstrated by some Dutch court decisions on a UK LLP, which does not have a capital divided into shares. Hence from a Dutch perspective, it has characteristics in almost equal measure of a partnership and a capital company. The District Court of The Hague, 26 February 2019, no. 18/1972 and 18/1974, ECLI:NL:RBDHA:2019:1565 regarded a UK LLP as transparent because it had more characteristics of a partnership. The Court of Appeal of Amsterdam 11 April 2017, no. 16/00225, ECLI:GHAMS:2017:2577 ruled that it was not in dispute that the UK LLP was to be considered as a transparent entity.

[896] This part of the Decree reflects a decision of the Dutch Supreme Court of 2 June 2006, no 40,919. BNB 2006/288, in which it confirmed that a US LLC was opaque. The Dutch tax authorities have apparently ruled that LLCs formed in a number of US states are non-"transparent" for Dutch tax purposes. However, as indicated below, the four-factor test in the Decree does not necessarily mean that every US LLC is opaque for Dutch tax purposes.

[897] See further discussion in Blanchard: Significance op.cit. at page 14.

partner; the latter cannot bind the partnership by making management decisions; and there is no share capital.

Finally, the Decree is not decisive where the non-Dutch entity is directly comparable with a Dutch co-operative or mutual insurance association.

The Ministry of Finance has published on its website a list of non-Dutch entities whose status has been ruled on by the Dutch tax authorities[898]. This list is merely indicative, like its UK counterpart: see 2.13. However, it is lengthier than the UK list. It also explains, in outline by reference to the four factors mentioned above, why an entity has been classified in a particular way for Dutch tax purposes, which makes it more useful than the UK equivalent. It has been regularly updated and the Dutch tax authorities will provide advance rulings on the classification of entities.

A couple of interesting points emerge from the Dutch list. The fact that an entity can own its own assets clearly does not prevent the Netherlands regarding it as transparent. However, the Netherlands generally regards LLCs formed in various US states as non-transparent, along with some limited liability partnerships (e,g, in Delaware but not in the UK) and all US limited liability limited partnerships.

Non-Dutch foundations, mutual funds, trusts and comparable entities fall outside the scope of the Decree. Such entities are to be classified on the basis of which domestic Dutch entity they most closely resemble. Non-resident non-Dutch mutual funds, trusts and similar entities could be regarded as special purpose funds, or “doelvermogens”, for Dutch tax purposes.

The Dutch rules on classifying entities do not deal in the same way with those which are, and those which are not formed under Dutch company law. This could give rise to questions about whether these Dutch rules are compatible with EU law: see 6.7.8.3.

7.3.4 *Lessons from the Dutch experience*

The Netherlands has adopted a method of classifying non-Dutch entities which is similar to the UK method, focussing on structural features of the relevant entity (especially non-Dutch entities) under its governing law and constitutional documents. It then uses these factors to identify the closest equivalent Dutch domestic entity. The factors chosen are not the same as those which are relevant in the UK and inevitably the choice of factors is somewhat arbitrary.

The Netherlands approach is simpler, and more mechanistic than that of the UK when applying the four classification factors which it usually regards as key. No one factor is conclusive under Dutch tax law and it is possible for an entity to be tax-“transparent” in the Netherlands by failing to satisfy at least two factors. An example would be an entity which own its own assets and whose members have limited liability but which lacks share capital and where members’ interests cannot be transferred without the consent of other members.

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[898] Clarification of 4 May 2016 (Lijst van gekwalificeerde buitenlandse samenwerkingsverbanden); https://www.belastingdienst.nl/wps/wcm/connect/bldcontentnl/themaoverstijgend/brochures_en_publicaties/lijst_van_gekwalificeerde_buitenlandse_samenwerkingsverbanden. For an unofficial English translation of this list, see the Annex to Molenaars op. cit.

The UK and Dutch approaches are not symmetrical. This alone could lead to entity classification mismatches, even though the approaches are broadly similar.

This more mechanistic Dutch approach provides taxpayers with more certainty about which factors count. In that sense, it is superior to the UK approach. The factors which count for Dutch tax purposes, together with a more mechanistic approach, affect how easily taxpayers can structure so as to achieve a desired tax outcome (e.g. a tax mismatch) in another jurisdiction.

The Dutch Decree on entity classification no longer places any emphasis on whether members are entitled to profits as they arise without an intervening resolution by a third party. It is also interesting that the Dutch Decree still attaches importance to legal personality, because this is a highly formalistic criterion and there are Dutch entities (notably, the "open" CV) which lack legal personality but are still subject to Dutch corporate income tax. The enduring significance of legal personality may be influenced by the rules applying to Dutch entities. In particular, there are no Dutch entities which have legal personality (i.e. the ability to own assets in their own right) but are fully "transparent" for Dutch tax purposes[899].

Limited liability and the free transferability of members' interests remain relevant factors for Dutch tax purposes. They can be quite readily manipulated by well-advised taxpayers, as in the US pre-1997. By contrast, centralised management of an entity is not a relevant factor yet is less easy to manipulate. Hence the Dutch rules offer significant de facto scope to pick a desired entity classification[900]. This is especially true when creating cross-border hybrid mismatches, and above all when the counterpart jurisdiction is the US. In that case, there is often no need to consider whether manipulating one or more factors for Dutch tax purposes adversely affects the desired US entity classification because the latter simply depends on a "check-the-box" election. For example, a Dutch "transparent" entity can be created by forming a "closed" CV, with significant limitations on transferring members' interests. This can, however, elect to be treated as a corporation for US tax purposes.

"Transparency" for Dutch tax purposes means that the profits of the entity are taxable at the level of its members, reflecting each member's tax circumstances. There is nothing akin to disregarded entity status in the US. On the other hand, the Netherlands does not subscribe to the concept of "translucency" applied to partnerships in France and discussed at 6.5.1 above: France is an outlier in this regard.

Historically, the Netherlands has not had controlled foreign company rules, apart from Section 13a CITA which can require marking-to-market of shareholdings of at least 25% in non-Dutch companies which are taxed at an effective rate below 10% and which hold mainly portfolio investments. Therefore, optimal classification of non-Dutch entities to avoid exposure under controlled foreign company rules has not been a major issue. That may change now that the Netherlands has enacted

[899] In this sense, the Dutch entity classification rules may be similar to the UK rules. The latter have historically attached great importance to the presence or absence of legal personality, not least because an English partnership is only a contract between partners based on mutual agency. There is in fact draft legislation to change the Dutch Civil Law Code so that all Dutch partnerships will have legal personality. This is not expected to affect the tax transparency of such partnerships, nor the Dutch tax classification of non-Dutch entities.

[900] The Dutch authorities do not seem concerned that this creates an unlevel playing field between well-resourced and less well-resourced taxpayers.

such rules to satisfy Article 7 of the EU Anti-Tax Avoidance Directive 2016[901]. However, the Netherlands does not appear to have enacted very stringent controlled foreign company rules. In particular, in an International Tax Policy Letter dated 23 February 2018, the Dutch government announced[902], inter alia, that there will be no controlled foreign company liability if the non-Dutch company in question demonstrates adequate substance by incurring at least Euro 100,000 per annum in payroll expenses; and has office space generally available for its use.

The Netherlands is in any case taking steps to limit its attractiveness as a location for hybrid structures, in the wake of BEPS and the EU Anti-Tax Avoidance Directive. In particular, anti-"reverse hybrid" rules take effect from 1 January 2020, in line with Article 9a of that Directive. These will target the hitherto popular CV/BV structures much used by US multinationals. Therefore, there are likely to be reduced opportunities for taxpayers to create profitable mismatches by exploiting the Dutch entity classification rules.

The Netherlands is concurrently broadening its exemption from dividend withholding tax (based on the EU Parent-Subsidiary Directive) so that it also applies to certain corporate shareholders resident in Dutch treaty partner jurisdictions outside the EU. When applying this widened exemption to dividends paid to hybrid entities, the Netherlands will not simply classify the hybrid according to its own domestic entity classification rules. Instead, it will apply the exemption in a manner similar to Article 1(2) of the OECD Model. Hence it will give priority to the classification of that hybrid entity in the jurisdiction where its members are resident[903]. Hence the exemption will not apply to hitherto popular Dutch "reverse hybrid" structures, such as CV/BV structures[904].

8. Conclusion

8.1 How does the UK classify entities for tax purposes and when and how does it regard an entity as being tax "transparent"? Is its approach to entity classification satisfactory, especially taking into account its double taxation treaties and EU law? Is an alternative approach to be preferred?

The preceding Chapters have broken this larger question down into a number of sub-questions. It is helpful to summarise the answers to those before setting out some more general conclusions on the UK approach to entity classification and tax "transparency".

8.1.2 Why is it important to classify entities for UK tax purposes?

The UK tax system cannot delineate its own boundaries effectively without having rules defining what entities and arrangements are potentially taxable or are otherwise tax-significant (rather than tax "nothings"). For further discussion of this, see 1.1 and 8.2.

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[901] Council Directive (EU) 2016/1164 of 19 July 2016, as amended by Council Directive (EU) 2017/952 of 29 May 2017.

[902] For much of what follows, see www.debrauw.com/expertise/tax/8 March 2018 - "Dutch Government announces corporate tax avoidance plans, responds to ECJ decision".

[903] Article 4(9) and (10) of the Wet op de dividendbelasting 1965 (Dividend Withholding Tax Act 1965/hereafter 'DWTA'.

[904] See www.debrauw.com/expertise/tax/22 September 2017 - Dutch Tax Bill 2018: what will change? (accessed 7 July 2020).

8.1.3 How does the UK do this, especially in relation to companies, partnerships and trusts?

The UK entity classification rules (especially in relation to companies, partnerships and trusts) are summarised in 3.9, 4.3.7 and 8.6.1.

8.1.4 What is the connection between classifying entities and "tax transparency"?

This is summarised in 1.2 and in 8.3.

8.1.5 What does "tax transparency" mean in UK tax law? Does it have more than one meaning?

"Tax transparency" means a number of different things in UK tax law, in relation to different entities and different contexts (and especially different taxes). These separate strands of meaning have evolved largely independently and somewhat piecemeal. The result is often a certain amount of confusion in applying these concepts. The meaning of "transparency" in relation to trusts depends on the tax and the type of trust. In particular, it is summarised in 4.3.7 for the purposes of income tax and capital gains tax. The special meaning of "transparency" in relation to partnerships for the purposes of taxing capital gains is summarised in Appendix A.10.

There is a more general summary of what "transparency" signifies, in relation to UK taxes other than those on income and gains, in 5.8. This includes whether a corporate affiliation relationship can be "traced" through "transparent" partnerships. This is also discussed in Appendix A.10.

8.4 discusses to what extent "transparency" is a concept which differs from the (many) rules allowing income and gains of an entity to be attributed to other persons with an interest in it (e.g. shareholders of a company and settlors or beneficiaries of a trust).

8.1.6 How do UK double tax treaties address entity classification and tax transparency issues, especially when the UK and its treaty partners classify an entity in different ways?

The UK has addressed entity classification and "transparency" issues in its tax treaties broadly along the lines endorsed by the OECD since the 1999 Partnerships Report: see 6.8.1 and 6.8.6. The new Article 1(2) of the OECD Model and Article 3(1) of the MLI should reinforce this trend. However, there are exceptions to this pattern e.g. the UK-France treaty, which reflects particular French issues in this area, and the UK-US treaty, which reflects longstanding US treaty negotiation priorities (some of which coincide with what is now mainstream OECD thinking). The UK's estate and gift tax treaties are a neglected backwater, with a number of these treaties not reflecting OECD standards in this area: see Appendix C.2.7.

8.1.7 Is the UK approach to entity classification affected by EU law?

In a number of respects, the UK rules regarding the classification of entities and their "transparency" seem inconsistent with the EU "fundamental freedoms": see 6.8.7.5.

8.1.8 Is the approach of other jurisdictions (in particular, the United States and the Netherlands) to these issues instructive?

The Netherlands operates (see 7.3) a "resemblance" test (not dissimilar to the UK's) for classifying non-Dutch entities. It exhibits many of the weaknesses of such tests but is more clearly articulated and easy to administer than the UK equivalent. Hence it is more user-friendly.

The US abandoned (see 7.2) its old "four factor" resemblance test in 1997 and moved to the (in)famous "check-the-box" system. Descriptions of that system have tended to exaggerate some of its features but there is no doubt that it is a fertile source of entity classification mismatches. However, with modifications, it could provide a basis for reforming the UK entity classification rules so that they are more user-friendly, without ushering in a new era of mismatch-based avoidance activity.

8.1.9 What are the weaknesses in current UK thinking on "tax transparency" and entity classification? How can it be improved?

Existing weaknesses in this area and possible improvements are discussed in more detail in 8.3 and 8.6.

8.2 *The relevance of "entity classification"*

Entity classification is at the core of defining the boundaries of a tax system.

A tax system cannot delineate its own boundaries without defining those persons which (i) are liable for the relevant tax or (ii) even if they are not (e.g. partnerships and trusts), are still treated for tax purposes as separate entities whose status as such can influence the tax liability of others (e.g. the members of a partnership or, in the case of a trust, the settlor and beneficiaries).

Defining natural persons (i.e. individuals) as taxpayers is relatively straightforward, although they may have different (in)capacities from time to time e.g. when individuals are minors, mentally ill or act as trustees. It is harder to pin down those arrangements which should be treated as legal persons, not "nothings", for relevant tax purposes. Some such legal persons may pay direct taxes in their own right (e.g. companies, UK "authorised unit trusts" or discretionary trusts with UK-resident trustees), if they have the necessary territorial link to the taxing jurisdiction. Other legal persons or arrangements may still not be direct taxpayers themselves (e.g. partnerships or trusts falling within Section 60 TCGA), even if they have that territorial link. Nevertheless, their very existence may influence the liability of others, especially those with an economic interest in them. In short, these other non-taxable legal persons or arrangements may not be tax "nothings". An example is where two companies are regarded as "related" or "connected" because they are under the common ownership or control of a third entity (e.g. a partnership) which itself has no substantive tax liability. Yet the role of the partnership, which is not a tax "nothing", creates a connection between the two companies. That connection may then affect, for example, the value placed, for tax purposes, on transactions between those companies.

A tax system will in particular need to define whether arrangements outside its territorial jurisdiction constitute legal persons and if so, what sort. This will be essential when taxing investment into that jurisdiction, as well as investment by its residents in other jurisdictions. A good example is when taxpayers resident in one jurisdiction, A, have economic interests in an entity or arrangement which is located outside A and which may pay tax elsewhere on its activites. The way in which A defines that entity or arrangement will affect how A's own residents are taxed and, in particular, their right to any double taxation relief in A for non-A tax on that entity or arrangement. Double taxation relief may well be restricted if A treats that non-A entity or arrangement as a company, rather than a partnership or a trust.

8.3 *The multifaceted concept of "tax transparency"*

The fact that an entity is classified in its home jurisdiction as having no tax liability of its own, ushers in the related and chameleon-like concept of "tax transparency". Entity classification rules are often key in deciding whether, and how, such an entity or arrangement is "tax transparent", not least because the usual starting point is that "companies" are not "transparent" but "partnerships" are.

"Tax transparency" is shorthand for those situations where persons with an interest in an entity or arrangement are taxed as if they were directly, not indirectly, carrying on the underlying activities of that entity or arrangement and/or owning its assets. Hence the tax liability on those activities and assets is essentially determined at the level of those with an interest in the entity, and taking full account of their tax profile. In such cases, the entity itself will have no substantive liability of its own. It may have a "representative" liability (e.g. the UK-resident trustees of an English law trust which has a vested income beneficiary). If so, tax can be provisionally collected from it on behalf of those with an interest in it, but the tax circumstances of those interest holders will decide the ultimate tax liability in respect of the activities of that entity[905]. So if those with an interest in that entity are tax-exempt, that may trigger a refund of any tax provisionally collected at the level of the entity.

"Tax transparency" classically means that the profits of the entity are taxed in the hands of those with an interest in it, whether or not they are distributed. In other words, there is no scope for deferral. Unless those persons can ensure that funds are released to them by the entity on time, they may have to fund from other sources the tax on any undistributed income and gain. "Tax transparency" can therefore be problematic where an entity has a large and fluctuating body of members, especially if each member has limited influence over its affairs. Such members may have liquidity issues when paying tax on their share of undistributed profits, unless (as is common) the entity commits contractually to distribute enough money to enable members to pay such tax. Tax authorities will also want to avoid pursuing a large and fluctuating body of members of a "transparent" entity for fairly small amounts of tax on fairly small profit entitlements. This collection problem can be resolved by imposing on the entity a representative liability on behalf of its members which is set high enough to collect most, if not all, of their ultimate tax liability. Members can then seek refunds if, in their specific circumstances, that representative liability turns out to be too high.

The classical conception of "tax transparency" does not work well in relation to trusts with discretionary beneficiaries, whose interest in trust profits is highly contingent. Taxing them on undistributed profit would make little sense.

"Tax transparency" is the converse of the way in which companies are normally taxed. With limited exceptions (such as UK LLPs and EEIGs), the UK, like most jurisdictions, treats companies as taxable entities in their own right, notably in respect of their income and gains. The company's tax liability is not a representative liability on behalf of, and ultimately determined by reference to the tax profile

[905] As in *Williams v Singer* 7 TC 387, discussed at 4.3.3.1.

of, its members[906]. Hence the nature, extent and timing of that liability is not normally affected by the tax characteristics of the company's members e.g. where they are resident and what reliefs and exemptions they are entitled to.

This raises concerns about whether members of a company are exposed to economic double taxation of income and gain: once at the level of the company itself and then again if and when income and gain (net of company-level tax) is distributed to members, or value is otherwise realised by them (e.g. when they sell shares in the company). There has long been a debate about whether, when and how to alleviate such economic double taxation. Some jurisdictions (e.g. the USA) do relatively little to alleviate the economic double taxation of distributed profit[907]. Their systems of taxing corporate profits are often referred to as "classical systems".

The UK began with such a system in 1965 when corporation tax was first introduced. For the purposes of taxing non-corporate shareholders, it largely reverted to such a system in 2016 but UK corporate shareholders typically benefit from an exemption on distributed profit. From 1973 until 2016, the UK experimented with various devices to give non-corporate members some relief, against their own tax liability on distributed profits, for tax already borne at company level. The full story of how these devices) known as "partial imputation systems") evolved (and were adversely affected by EU law) is beyond the scope of this thesis. However, they never gave members of a company full relief (including a refund) for company-level tax. While members were not usually taxed on undistributed corporate profits, the company was taxed on them anyway. Its liability on undistributed profits did not reflect the particular tax profile of its members. However, that company liability was typically imposed at rates well below marginal income tax rates for individual members. Hence if company profit was not distributed, the lack of transparency in fact reduced the effective rate of taxation on those members[908].

"Tax transparency" is mainly encountered when taxing income and gains of an entity or arrangement. Here it also usually means that a person with an interest (an "interest holder") in the entity or arrangement is treated as entitled to income or gain of the same character as the underlying income or gain of the entity or arrangement. However, for an entity or arrangement to be "tax transparent", must the interest holder be taxable on a percentage of underlying income or gain exactly corresponding to its pro rata interest in the entity or arrangement? Moreover, must it become entitled to that income or gain for tax purposes as soon as it arises to the entity or arrangement, even if it is not then distributed to the interest holder?

As already mentioned the classic answer to both these questions is "yes". However, "tax transparency" is a number of variations on a theme. One form of UK tax transparency exists where a life interest holder in an English law trust is regarded as entitled to distributed or undistributed income of the same **character** as that arising to the trustees from their activities, even if the **quantum** of that entitlement is reduced by taxes and other trust expenses which the trustees may deduct when

[906] In purely economic, not legal, terms, the company is of course being taxed as a proxy for its members.
[907] But see the new US corporate shareholder exemption for non-US dividends discussed in 7.2.6.2.3. For a summary of the competing arguments about how best to deal with economic double taxation of corporate profit, see "Tiley's Revenue Law" (9th edition), Loutzenhiser at pages 1095-1100.
[908] Of course a low headline rate of corporation tax is but one factor in determining whether there is a low effective rate of corporation tax.

calculating the life interest holder's precise entitlement[909]. It can also be argued that, so long as trust beneficiaries are treated as entitled to income and gain of the same character as that arising to the trustees, it matters less whether that entitlement arises precisely when the income or gain arises to the trustees. Hence another, modified form of "tax transparency" arguably exists where the beneficiaries of a discretionary trust are treated as entitled to a blended mix of the underlying income arising to the trustees, but only if and when that income is subsequently distributed to them[910].

More radical variants of "tax transparency" exist compared to those described above. It is not a single concept, as tax planners know, and its precise form will depend on the specific rules which are being applied. Hence, in UK income tax law, partners in a partnership are regarded as carrying on the underlying business of the partnership collectively so that they are entitled to the distributed and undistributed profits of that business, and incur its losses, in direct proportion to their profit-sharing entitlements. This goes beyond merely saying that the source and character of their income is unaffected by interposing the partnership[911]. When taxing partnership capital gains, UK tax law goes even further (in Sections 59 and 59A TCGA, amplified by Statement of Practice D12): it treats each partner as having a fractional interest in each and every underlying partnership asset. The size of these deemed co-ownership interests of partners corresponds to the partnership's profit–sharing arrangements. They are a tax fiction because a partner cannot usually say that it is entitled to a specific undivided interest in any partnership asset[912]. Sections 59 and 59A TCGA are burdensome because each partner must keep track of its fractional interests in the underlying partnership assets, its base cost in each of those interests as well as any relevant increases or reductions. Increases and reductions in fractional interests can sometimes be taxable disposals, in which an unfunded tax liability may arise[913].

Occasionally, UK tax law adopts a less radical transparency analysis when taxing partnership capital gains: see Schedule 7AD TCGA, where an insurance company is a limited partner in a "venture capital investment partnership"[914]. In that case Section 59 TCGA 1992 is largely disapplied.

Whatever form it takes, "tax transparency" rarely means that one can disregard altogether for UK tax purposes an entity or arrangement i.e. treat it as a tax "nothing" so that, for example, one can trace degrees of affiliation between other taxable persons via that entity or arrangement as if it simply did not exist. A rare non-UK example of such a tax "nothing" can arise under the US "check-the-box" regulations where a single-member "eligible entity" (e.g. a single-member LLC) is "disregarded" for Federal tax purposes. In that case, the entity is simply treated as a branch of the single member[915]. Hence transactions between the entity and the single member are in principle ignored, because the entity has ceased to have a separate tax existence.

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[909] See *Baker v Archer-Shee* 11 TC 749 and related cases in 4.3.3 above.
[910] See *Drummond v Collins* 8 TC 525.
[911] See, for income tax purposes, Sections 846 et seq. ITTOIA.
[912] This is true in relation to both English and Scottish partnerships. For a discussion of this issue, see *Bayonet Ventures LLP and another v HMRC* [2018] UKFTT 262 (TC) and *Hadlee v Commissioner of Inland Revenue* [1993] STC 293 at 297-8.
[913] Statement of Practice D12 (as revised) seeks to mitigate some of this tax exposure, especially when partnership sharing ratios change e.g. on the departure of a partner or the admission of a new partner.
[914] As defined in paragraph 2 Schedule 7AD.
[915] See 7.2.4.2. The US "grantor trust" rules can have a similar effect, although the same cannot be said of their UK equivalent, the "settlement" rules, in Part 5 Chapter 5 ITTOIA.

Another rare example of an entity being disregarded for tax purposes arises in relation to VAT. If two companies elect to be treated as a "group", the VAT legislation in principle treats the group members for most purposes as being one person only i.e. whichever group member is chosen to be the so-called "representative member". In most cases, transactions between the group members are therefore disregarded[916].

The VAT example also shows that the "tax transparency" concept is not confined to taxes on income and gains, but that is where it is mainly encountered. By contrast, single entities are not usually regarded as "transparent" for VAT purposes and this is increasingly true in relation to Inheritance Tax, since the 2006 changes to the taxation of "settlements". Even in relation to the tax on income and gains, some entities (notably trusts) which one might expect to be "transparent" may in fact be "opaque" or, at least, only partly "transparent", depending on the tax in question and the nature of the beneficial interests in the trust.

8.4 *"Tax transparency" versus anti-avoidance attribution rules: what is the difference and when does it matter?*

Whether there is transparency, and what form it takes, are policy choices to tax certain persons or arrangements in a particular way. The "tax transparency" concept is not self-evident[917]. Where this concept treats the holder of an interest in an entity as entitled to underlying income or gain, whether or not distributed, then it fulfils a function quite similar to the many tax rules (e.g. the UK "controlled foreign company" rules[918] and the income tax "settlement" rules[919]) which combat tax deferral or avoidance by imposing current-basis taxation on accrued but undistributed income or gain of an entity or arrangement.

However, the effect of "tax transparency" is not quite the same as those other rules ("**attribution rules**") and overall, it is helpful to distinguish between the two. Such attribution rules tend to contain quite carefully designed exceptions to the general attribution rule, including defences based on the taxpayer lacking an avoidance motive[920]. Such rules only attribute income to a non-UK-resident taxpayer in limited situations: see fn7. Where an arrangement is treated as "tax transparent", such exceptions are less likely to exist. Tax on distributed or undistributed income and gain will simply be charged by reference to the pro rata interest of the taxpayer in the "transparent" entity or arrangement. That will be true whether or not the taxpayer is UK-resident.

Conversely, where such attribution rules bite, they may be quite sweeping, even draconian. This is because they have an explicit or implicit[921] goal of counteracting avoidance. For example, where the "settlement" rules in Chapter 5 Part 5 ITTOIA bite, the "settlor" can be taxed on attributed income from the "settlement" even if as a matter of contract or property law, the "settlor" has no meaningful

[916] For further discussion, see 5.4.5.
[917] Even though it is very long-established in some areas e.g. the income taxation of partnerships, where it goes back to the very origins of UK income tax at the start of the nineteenth century.
[918] Part 9A TIOPA.
[919] Part 5 Chapter 5 ITTOIA.
[920] E.g. Part 9A Chapters 9 and 11 TIOPA, in relation to the "controlled foreign company" rules; and Section 742A ITA in relation to the "transfer of assets abroad" rules.
[921] Such rules do not always explicitly articulate an anti-avoidance purpose. The "settlement" rules in Part 5 Chapter 5 ITTOIA do not (unlike the "transfer of assets abroad" rules in Part 13 Chapter 2 ITA), although they do require in essence a non-arm's length arrangement (the so-called "element of bounty").

claim on that income[922]. The "settlor" charge applies in essence because the "settlor" has instigated the arrangement, and is regarded as having ongoing influence over it, even if others (e.g. minor children) are its economic beneficiaries. By contrast, where an arrangement is "tax transparent", the tax liability of a person with an interest in that arrangement will be more tightly linked to their actual economic stake in the underlying activities. This is because arrangements are not usually treated as "tax transparent" in order to combat avoidance. Hence the income tax liability of a partner in a partnership will be measured by reference to that partner's profit-sharing entitlement[923], whether or not the partner has significant influence within the partnership. Under the rule in *Baker v Archer-Shee,* the holder of the interest in possession in the trust is only entitled for tax purposes to those underlying income items which would also be income for trust law purposes. In short, only those items which it could demand from the trustees in its capacity as income beneficiary[924].

Furthermore, attribution rules of the kind mentioned above do not always treat the taxpayer as entitled to the actual underlying income or gain of an entity or arrangement. This is true, for example, of the UK "controlled foreign company" rules[925], which impose a tax charge on a separate notional amount computed by reference to certain types of income, but not capital gains, of the "controlled foreign company". Atypically, the UK rules for taxing "participators" on the chargeable gains of non-UK-resident "close companies" purport to tax the company's actual gain, at least where the "participator" has a direct interest in that company: see Section 3 TCGA[926].

UK attribution rules do not usually disregard the entity or arrangement at which they are targeted[927]. Hence they do not go as far as the more radical variants of "tax transparency". They usually operate asymmetrically, attributing amounts in respect of income and gain, but not losses, to the taxpayers caught by them. This is consistent with their anti-avoidance rationale. By contrast, in cases of "tax transparency", it is more common to treat the interest holder as entitled to relief for underlying losses of the entity, in proportion to its economic interest, as well as being taxable on its share of underlying profits. This is certainly true in relation to partnerships and trusts with vested concurrent beneficial interests in both income and capital. However, it is not the case in relation to vested income interests in trusts[928].

There is therefore a meaningful distinction in UK tax law between cases of "tax transparency" and, on the other hand, attribution rules. However, there is one area where it makes sense to treat attribution rules as a form of "tax transparency". This area involves "fiscal transparency" clauses of the kind which are increasingly widespread in UK tax treaties, not least because of Article 1(2) of the OECD Model and Article 3(1) of the MLI). Article 1(2) in particular applies to "income derived by or

[922] Other than in highly contingent situations.
[923] See, for example, Section 850 ITTOIA, together with Section 12ABZB TMA.
[924] See 4.3.3.
[925] See *Bricom Holdings Ltd v IRC* [1997] STC 1179. A similar approach is now adopted by the "transfer of assets abroad" rules in Part 13 Chapter 2 ITA, following changes in 2013: see in particular Section 721(3B) and Section 728(1A) ITA.
[926] This means that, in contrast to the "controlled foreign company" rules and "transfer of assets abroad" rules, double tax treaty protection may override the Section 3 charge where the non-UK-resident company is treaty-protected, although this override is denied where the "participator" is a trust: see Section 79B TCGA. In any case, such treaty protection is unlikely to survive as UK treaties increasingly include the kind of "saving" clause in Article 1(3) of the OECD Model and Article 11 of the MLI.
[927] Unlike, for example, the US "grantor trust" rules.
[928] Under the rule in *Baker v Archer-Shee.*

through an entity or arrangement that is treated as **wholly or partly fiscally transparent** [emphasis added] under the tax law of either Contracting State".

Article 1(2) has been discussed at 5.2. The author considers (for the reasons given in 6.4.2) that, if one adopts a purposive interpretation of Article 1(2) of the OECD Model and Article 3(1) of the MLI[929], such attribution rules do give rise to a form of "fiscal transparency". Otherwise the underlying purpose of Article 1(2) and Article 3(1) may well be frustrated. Article 1(2) applies if the income in question is liable to current taxation in the hands of a resident of the non-source contracting state. It should not matter how that liability is achieved mechanically, so long as it is achieved in substance. The words "fiscally transparent" should be read accordingly.

Consequently, if an entity is regarded as "opaque" for tax purposes in the residence state of an entity member (e.g. a shareholder), but that member is currently taxable in that state on an attributed amount (e.g. under a "controlled foreign company" rule) reflecting some or all of that entity's income from the other contracting state, then failing to apply Article 1(2) would largely frustrate its purpose. That situation does not differ materially from where the entity is regarded as a partnership by the residence state of the member, so that the latter is currently taxable on an allocated share of the entity's underlying income.

Concerns may be raised that if Article 1(2) is interpreted in this way, then this may limit, via treaty, the scope of a domestic anti-avoidance regime. Such concerns can be addressed, not least by the type of "saving" clause long present in US treaties, and now much more widespread because of Article 1(3) of the OECD Model[930]. "Saving" clauses ensure that the treaty does not remove the right of the state where the entity member is resident to tax that member (notably under attribution rules) as if the treaty did not exist[931]. Nevertheless, a "saving" clause will usually preserve the right of a resident of that state to claim double taxation relief (by credit or exemption) under the "Elimination of Double Taxation" Article in that treaty. This Article may give more generous relief against the residence state tax charge than would be available otherwise. However, that does not justify denying relief in the source state (via Article 1(2) of the OECD Model or Article 3(1) of the MLI) where a resident of one state is currently taxed under attribution rules in respect of income of an "opaque" entity which is sourced in the other state.

8.5 *Entity classification and "tax transparency": key aspects of tax sovereignty*

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929 See the dicta of Mummery J. (as he then was) in *IRC v Commerzbank AG* [1990] STC 285. Mummery J's exposition of the purposive UK approach to interpreting tax treaties, based on Articles 31-2 of the 1969 Vienna Convention on the Law of Treaties, has been frequently cited in subsequent cases as a classic summary of the general approach, although limited aspects of it are open to question. For a fuller discussion, see Philip Baker: "The *Commerzbank Litigation (1990)* UK Law, Tax Treaty Law and EU Law" Chapter 15 "Landmark Cases in Revenue Law" ed. John Snape and Dominic de Cogan. Hart Publishing 2019 and especially at pages 335-341. As Philip Baker rightly points out, the interpretation of the 1945 UK-US treaty which Mummery J in fact adopted in that case was rather literal, despite his general comments on treaty interpretation. Furthermore, from a US perspective, it was excessively generous to the taxpayer.

930 Also Article 11 of the MLI.

931 Hence the taxpayer's claim for treaty relief in a case like *Padmore v IRC* [1989] STC 493 would fail. As discussed in 6.2, the situation in *Padmore* has already been addressed via a retrospective treaty override, as well as changes to UK tax treaties.

If a jurisdiction is to preserve its own tax sovereignty and its tax base, then its laws must define those persons which are of relevance when imposing its taxes, especially those entities which it regards as taxpayers in their own right. Ceding control of those definitions to other jurisdictions, or to supranational laws and courts, means losing control of the shape and structure of a jurisdiction's tax system. For example, if the UK does not have the final say over what is a "company" for the purposes of its corporation tax, then it lacks control over the extent of that tax. Deciding what is and is not a "company" may also be relevant in determining other aspects of the UK tax base e.g. the extent of any double taxation relief where a UK-resident individual bears the economic burden of non-UK tax on the profits of a non-UK entity in which that person has invested.

Some jurisdictions (e.g. South Africa in some cases[932]) have nevertheless been prepared to part-align their own rules on defining entities with those of other jurisdictions, when deciding the tax treatment of cross-border arrangements. The extent of such alignment varies. It can of course significantly reduce entity classification mismatches which can lead to tax avoidance. However, this non-autonomous classification approach is the exception rather than the rule. It erodes tax sovereignty by tying the boundaries of one jurisdiction's tax system to the entity classification choices (present or future) of another jurisdiction. It may also give rise to further mismatches in situations involving third countries, unless it can be selectively overridden so as to prevent further avoidance. Even within the EU, this non-autonomous classification approach has not found much favour. When the EU Anti-Tax Avoidance Directive[933] was first mooted in 2015/6, suggestions were made[934] that it should impose on Member States uniform entity classification rules so as to avoid double non-taxation. Article 10 of the original text therefore read:

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[932] In particular its rules regarding "foreign partnerships" in Section 1 of the South African Income Tax Act. This concept is designed to ensure that entities such as US LLCs and UK LLPs are treated as partnerships, not companies, for South African tax purposes, despite them having legal personality. The definition in Section 1 reads: "'foreign partnership', in respect of any year of assessment, means any partnership, association, body of persons or entity formed or established under the laws of any country other than the Republic if—

(*a*) for the purposes of the laws relating to tax on income of the country in which that partnership, association, body of persons or entity is formed or established—(i) each member of the partnership, association, body of persons or entity is required to take into account the member's interest in any amount received by or accrued to that partnership, association, body of persons or entity when that amount is received by or accrued to the partnership, association, body of persons or entity; and (ii) the partnership, association, body of persons or entity is not liable for or subject to any tax on income, other than a tax levied by a municipality, local authority or a comparable authority, in that country; or

(*b*) where the country in which that partnership, association, body of persons or entity is formed or established does not have any applicable laws relating to tax on income—(i) any amount—(*aa*) that is received by or accrued to; or (*bb*) of expenditure that is incurred by, the partnership, association, body of persons or entity is allocated concurrently with the receipt, accrual or incurral to the members of that partnership, association, body of persons or entity in terms of an agreement between those members; and

(ii) no amount distributed to a member of a partnership, association, body of persons or entity may exceed the allocation contemplated in subparagraph (i) after taking into account any prior distributions made by the partnership, association, body of persons or entity." http://sars.mylexisnexis.co.za/# (accessed 14 July 2020). This definition is intended to incentivise foreign investment in South Africa. The highlighted carve-out for municipal, etc taxes is designed to ensure, in particular, that German partnerships are "foreign partnerships," even though such partnerships are subject as such to the German municipal trade tax ("Gewerbesteuer").

[933] Directive 2016/1164 of 19 July 2016, as amended by Directive 2017/952 of 29 May 2017.
[934] See "Hybrid Mismatches under the ATAD I and II" G.K. Fibbe and A.J.A. Stevens. EC Tax Review 2017/3 page 153 at 154.

> "Where two Member States give a different legal characterisation to the same taxpayer (hybrid entity), including its permanent establishments in one or more Member States, and this leads to a situation where a deduction of the same payment, expenses or losses occurs both in the Member State in which the payment has its source, the expenses are incurred or the losses are suffered and in another Member State or a situation where there is a deduction of a payment in the Member State in which the payment has its source without a corresponding inclusion of the same payment in the other Member State, the legal characterisation given to the hybrid entity by the Member State in which the payment has its source, the expenses are incurred or the losses are suffered shall be followed by the other Member State."

This draft Article only addressed mismatches giving rise to (i) a double deduction mismatches and (ii) mismatches where a payer deduction did not give rise to a payee income inclusion. It gave priority to the entity classification in the Member State where a payment was sourced. It would not have addressed classification mismatches involving transactions with non-EU jurisdictions (notably, the USA). The draft Article was abandoned, despite support from the European Parliament[935]. Instead, Articles 9 and 9a of that Directive follow the BEPS Action 2 Recommendations more closely. Therefore, Article 9 simply counteracts some of the double non-taxation effects of classification mismatches, without altering entity classification. Article 9a (see 6.8.7.2) imposes non-"transparent" treatment on "reverse hybrids" in certain intra-EU situations. Where it applies, it takes priority over Article 9[936]. Therefore, the Directive in its final form (like BEPS Action 2) does not significantly challenge the right of Member States to formulate their own entity classification rules.

Of course, if a jurisdiction retains full control of how to characterise legal persons and arrangements for tax purposes, classification differences may well arise with other jurisdictions. That creates scope for planning to achieve abnormally low rates of effective taxation. It is those planning opportunities which are partly addressed in the first part of the OECD's October 2015 recommendations regarding BEPS Action 2, and in Articles 9 and 9a of the EU Anti-Tax Avoidance Directive.

Particular problems arise when classifying entities or arrangements formed outside the relevant jurisdiction, under other legal systems. In a global economy, such problems are far from rare. It is likely to be hard to apply the relevant jurisdiction's criteria for classifying its own domestic entities to entities or arrangements formed under another system of law. The laws of other jurisdictions will often be based on a different underlying culture and legal tradition. In Europe and the United States, it is important to distinguish between common law entities and those stemming from the civil law tradition. In addition, within both common law and civil law traditions, different jurisdictions take different approaches about what entities can be formed and their nature and attributes. To take the common law as an example, an English law general partnership is never regarded as an entity distinct from its partners but the same is not true of partnerships formed under the laws of the states of the USA, or indeed under the law of Scotland (which is a "mixed system" borrowing from both the common law and the civil law).

[935] See Parada: Article 1(2) op. cit. at pages 372-3.

[936] Article 9a is not dissimilar to rules enacted previously in Denmark to counteract mismatches involving Danish hybrid and "reverse hybrid" entities. For further detail, see Parada: Article 1(2) op. cit. at pages 370-1.

As part of its tax sovereignty, and as well as classifying entities, a jurisdiction must also be entitled to decide whether and how to treat an entity or arrangement as “transparent”. This is true whether it is formed under the laws of that jurisdiction or elsewhere. The question whether and how an entity or arrangement is “transparent” need not always be the same as the question of how to classify it. For example, the Supreme Court in *Anson v HMRC*[937] concluded that the nature of an interest in a particular Delaware LLC was such that it was “transparent” for foreign tax credit purposes. The court did not definitively conclude[938] whether that LLC was a “company” or a “partnership” for UK tax purposes, because the rules it was considering did not require it to. However, that is not true of all rules and the way in which an entity is classified may well determine whether and how to treat it as “transparent”, because transparency is a key characteristic of some entities. In particular, if an entity is a “partnership” for UK tax purposes, then it will be “transparent” for the purposes of taxing its income and gains. That transparency will take the particular forms provided for in Section 850 ITTOIA and Section 59 TCGA.

8.6 *Weaknesses in the UK approach to entity classification and “tax transparency”, and suggested improvements*

8.6.1 *Entity classification*

The existing UK entity classification rules are an amalgam of specific statutory rules (of fairly limited ambit[939]); judicial decisions regarding mainly non-UK entities (and usually narrowly focussed on case specifics); plus published HMRC guidance (much of which purports to interpret the few judicial decisions to date). There is a clear statutory requirement to distinguish, for corporation tax purposes between “companies” on the one hand, and partnerships and trusts on the other[940]. “Companies” include “unincorporated associations” and there is controversy about what this category covers too[941]. Non-UK entities with a sufficient UK tax presence (in particular, those carrying on a trade of dealing in or developing UK land; or carrying on any other trade through a UK “permanent establishment”[942]) can be subject to corporation tax, but only if they are “companies”. Therefore, these classification categories potentially apply to entities formed outside the UK.

The rules for classifying entities or arrangements formed under English (or Scottish) law are fairly prescriptive. Hence there should be a high degree of certainty about whether such entities or arrangements are “companies”, partnerships or trusts for UK tax purposes[943]. The same is not true of entities or arrangements formed outside the UK. In such cases, the rules are vaguer, largely judge-made and more fact-sensitive. In essence, classification usually depends on deciding what English law entity most closely resembles the relevant non-UK entity or arrangement. This may not be easy to answer, not least because non-UK entities or arrangements may have no clear English analogue. A

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[937] [2015] STC 1777: see 2.14.
[938] The Supreme Court clearly did not want to delve too deeply into wider entity classification questions, such as the nature of a Scottish partnership versus a Delaware LLC. It was able to steer clear of such issues by focussing closely on the factual findings of the First-Tier Tribunal regarding Delaware law, together with the precise wording of the “Elimination of Double Taxation” Article in the UK-US double tax treaty.
[939] E.g. the rules deeming a UK LLP to be a partnership for direct tax purposes in most cases.
[940] Although some trusts e.g. “authorised” unit trusts and some “unauthorised” unit trusts, are explicitly subject to corporation tax.
[941] See 2.5.
[942] Section 5 CTA 2009.
[943] Although, as discussed in 2.5, there is some uncertainty about the meaning of “unincorporated association”.

good example of this is the foundation, or "Stiftung", which can be set up under the law of some civil law countries. Is this a company or is it a trust or is it something else[944]? If the question is being asked in the context of Inheritance Tax, does this entity still amount to a "settlement"[945] even if it is not a trust?

There is also no agreed hierarchy of key criteria for comparing a non-UK entity or arrangement with any UK counterparts. In contrast with the Netherlands (see 7.3), there is a non-exhaustive list of administrative guidelines from HMRC. With limited exceptions, there is no clear order of priority within these guidelines, which in any case purport to address the question of "transparency", rather than entity classification as such. Their status after the *Anson* litigation is unclear. Besides, the UK's more nebulous approach to classifying entities and arrangements not formed under English or Scottish law may well breach EU law.

Existing classification criteria focus mainly on matters which are of significance from the perspective of UK corporate and partnership law[946], without necessarily reflecting issues of importance under relevant non-UK legal systems. For example, Dutch law also classifies non-Dutch entities by seeking analogies with Dutch entities. In so doing, it places a much greater emphasis than the UK on whether entity members can freely transfer their interests in the entity.

Analysing the governing law of the relevant non-UK entity and then seeking its closest UK analogue is also problematic at a practical level. It depends heavily on the quality of expert evidence on pertinent aspects of the relevant non-UK governing law. The lack of clear classification criteria for non-UK entities, and their focus on UK-centric preoccupations, may lead to non-UK experts being asked questions about non-UK legal rules which are especially hard for those experts to understand[947], in addition to any language barrier.

The result is an expensive, cumbersome and protracted process which may well produce unsatisfactory answers to questions which are fundamental for UK tax purposes. The expert evidence can only ever be as good as the questions which the experts are asked. Experts can, and frequently do, disagree. The UK tribunal (which by definition is not expert in the relevant non-UK law) often has to adjudicate between expert opinions in order to make key findings of fact about the non-UK legal position. Those findings may be hotly contested by the parties (yet, being findings of fact, they are that much harder to appeal). For example, HMRC regard as wrong the key finding by the First-Tier Tribunal in the *Anson* litigation, that the LLC members in that case were contractually entitled, under Delaware law, to underlying LLC profits as they arose.

Even if the evidence of non-UK law in a particular case is clear or uncontested, it has no real weight as precedent because it is a finding of fact and no two cases are the same. Therefore, a decision in one

[944] See in this regard the discussion of *Sommerer* in 4.1.2.
[945] Within Section 43(2) IHTA: see 5.3.2. Can an entity be both a "settlement" and a "company" for Inheritance Tax purposes? *Sommerer* suggests that it can.
[946] For example, the intense focus on the presence or absence of legal personality as a key dividing line between companies and partnerships, although this focus should have lessened after *Anson*. To a US audience, the presence or absence of legal personality has little relevance for classification purposes.
[947] Such questions may only make sense, if at all, to those versed in the ways of the UK e.g. the question whether, for the purposes of the rule in *Baker v Archer-Shee,* a life interest holder in a trust is entitled to (i) underlying trust income as it arises to the trustees; or (ii) is only entitled to require the trustees to pay it a balance sum comprising the trust income less certain allowable trust expenses?

entity classification case may well not avoid the same laborious procedure in a similar, later case. Well-resourced and well-advised taxpayers have a very clear advantage when navigating the UK rules on classifying non-UK entities. This is exactly the imbalance between taxpayers which the US sought to address by introducing the "check-the-box" rules in 1997. Such an imbalance is hard to justify in a world where cross-border transactions are commonplace. However, it creates a "benefit", at least from HMRC's perspective: the ability of taxpayers to choose their preferred entity classification with certainty is limited because the current rules are cumbersome, uncertain and expensive to apply.

From a theoretical perspective, the UK approach to classifying non-UK entities risks basing important distinctions on esoteric points with little real-world relevance. The *Anson* litigation is a good example. The Supreme Court ruled in favour of "transparency" for UK foreign tax credit purposes because the LLC members were entitled to the underlying LLC profits as they arose (at least as a matter of contract), and were therefore not in the same position as the shareholders of a corporation, whose entitlement to profits requires a prior decision of that company to distribute profits[948], which in the first instance belong to the corporation itself. Yet in practice the LLC members in *Anson* were not much better placed than shareholders of a company in terms of their entitlement to receive distributions of profit. They may have had a theoretical profit entitlement in the LLC's books. Whether that book entry entitlement would ever be satisfied by an actual distribution was a separate question. In a world where the substantive difference between partnerships and companies is increasingly small, the UK entity classification rules seem to rely on criteria which have minimal business significance.

In order to escape from these problems, and to protect the UK corporate tax base from erosion, the UK should be much slower to confer on business entities (UK or non-UK) a status (in particular, partnership status) which would lead to "transparency". This would require reversing trends which have seen the UK treat large, centrally-managed UK and non-UK business entities (notably, UK and non-UK LLPs) as partnerships for most tax purposes. The result has been that, while such entities are quasi-private companies, that is not how they and their members are taxed.

Instead "transparency" should be reserved for those business organisations which are much smaller and looser-knit aggregations of persons, and in particular which are not "centrally managed" to any significant degree. This approach would be more faithful to the concept of "partnership" which the draftsman probably had in mind when introducing the "partnership" carve-out from corporation tax in 1965[949]. It would also greatly reduce the need for arcane legal analysis of non-UK entities to determine their UK tax classification. All other entities or arrangements (including business trusts) not within this limited "transparency" category would be regarded as companies for tax purposes. "Unincorporated associations" would cease to be a relevant tax category in their own right.

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948 *Re Accrington Corporation Steam Tramways Company* [1909] 2 Ch 40 and *Re Buenos Ayres Great Southern Railway Co. Ltd, The Company v Preston* [1947] 1 All ER 729, following *Bond v Barrow Haematite Steel Co.* [1902] 1 Ch 353. In those cases, preference shareholders were only entitled to a dividend paid out of (any) profits remaining after reserving or carrying forward in the accounts such amounts as the directors thought appropriate. Hence the preference shareholders did not have an unqualified contractual right to a distribution of the positive balance on the company's profit and loss account.

949 A decision would also need to be taken about which "transparent" entities or arrangements were regarded as a partnership for tax purposes, because there are special taxing rules for partnerships and not all "transparent" arrangements (e.g. simple co-ownership) are partnerships. In some cases, it may be appropriate to confer "transparency" on a business arrangement falling short of partnership under current standards e.g. a set of barristers' chambers.

This approach would also protect the employment income tax and National Insurance base[950]. In particular, there would be far fewer opportunities for senior personnel in so-called "partnerships" to use their "partner" status[951] to reduce income tax and National Insurance contributions on their remuneration. One can therefore expect opposition to any such proposed change[952]so an intermediate solution is set out below. This "halfway house" mitigates some problems with classifying non-UK entities by analogy with UK entities. It also tackles some of the artificial tax planning arising from treating large business entities as "partnerships", and hence "transparent".

This intermediate solution would involve switching to an entity classification regime which resembles the US "check-the-box" regime by being partly elective. While it is well known that HMRC is opposed to this, this switch need not involve a wholesale adoption of the US system. Like that system, there could be "per se" lists of UK and non-UK entities which would automatically be treated as companies for UK tax purposes and whose status could not therefore be modified by election. Those lists could be updated periodically to take account of new business entities. "Per se" categorisation is somewhat arbitrary but it ensures that the corporate tax base can only be modified by election within fairly tight boundaries.

As discussed in 7.2.5.1, the scope of the US "per se" list for non-US entities is quite limited. This need not be the case under a modified UK "check-the-box" approach. A UK "per se" list could include, for example, all entities formed under both UK and non-UK incorporation procedures, whether or not such entities were capable of offering securities to the public. Hence, a Dutch BV or a Luxembourg Sarl could be a "per se" company for UK tax purposes. The same could be true of a US LLC, although this raises harder questions. In particular, there is little meaningful legal and commercial difference between a US LLC and US limited liability partnerships yet HMRC have historically treated the latter as partnerships for UK tax purposes. Treating all US LLCs as "per se" companies would therefore create an arbitrary distinction between them and US limited liability partnerships, unless they too were treated as "per se" companies. That would probably be a step too far for an intermediate solution.

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[950] However, this approach may restrict the incidence of the new UK tax charge on the chargeable gains of non-UK-residents which are derived directly or indirectly from UK real property. That charge covers gains from direct disposals of interests in UK land (which would include an interest in a partnership to the extent that it held UK real property, because partnerships are "transparent"). The new charge also covers indirect disposals of UK real property, such as certain disposals of interests in a "UK land-rich" company. To be "land-rich", at least 75% of that company's gross assets must consist of interests in UK real property. Hence this new charge on non-UK-residents is less likely to apply if they own UK real property via a non-"transparent" company, rather than via a partnership.

[951] Such arrangements are routinely used in respect of senior UK-based personnel working for hedge funds, and private equity funds, especially where those personnel are non-UK "domiciled" for tax purposes. These arrangements of course include "carried interest" arrangements which can entitle senior staff to remuneration in a form taxed at much lower rates as capital gain, and which does not trigger National Insurance liabilities. They also include special partnership allocations of non-UK-source income and gain where the partnership has non-UK income sources. UK income tax on non-UK-domiciled staff in respect of such allocations can be deferred indefinitely, provided that they are not "remitted" to the UK. There are no National Insurance liabilities on such allocations if, in particular, they represent "profits of a trade, profession or vocation carried on wholly outside the United Kingdom": see Section 15(1)(c) Social Security Contributions and Benefits Act 1992.

[952] It may also be appropriate to offer a "transparency" regime, with safeguards, for some kinds of investment fund where professional investors value a fully "flow through" tax treatment. Any such regime would not extend to a management vehicle for that fund.

There is also no need to replicate in full the US disregard of a single-member "eligible entity" in some cases. That technique has been an especially fertile source of US mismatch planning. On the other hand, there is no need to replicate the US "publicly traded partnership" concept.

Adopting a system more like the US system would provide a less costly, less time-consuming and more streamlined approach to entity classification issues, while reducing the existing advantage conferred on well-advised and well-resourced taxpayers. It would also steer classification away from detailed analysis of non-UK law, plus esoteric classification criteria which are often based on an incomplete understanding of the relevant non-UK legal system.

In response to the HMRC concerns mentioned above, several points can be made. First, since 2016, the UK has radically revised and extended its rules for counteracting the tax avoidance effects of "hybrid mismatches", including mismatches which can be more readily created because of an elective system for classifying entities. The new rules are in Part 6A TIOPA and would continue to apply regardless. Concerns have been raised about the new Part 6A (notably, its very broad scope, uncertainty about how parts of it operate and the fact that it applies automatically, even to commercially motivated structures). However, these concerns exist already. Moving to a more elective classification regime would not make this worse.

Part 6A does not deal with all possible hybrid mismatches for UK tax purposes. For example, it only applies for corporation tax, not income tax purposes. However, a "targeted anti-avoidance rule" ("TAAR") could also be introduced to restrict significantly tax-motivated entity classification elections, if a more elective system were adopted. That TAAR would need to be drafted so as to avoid making all entity classification elections ineffective for tax purposes[953]. However, quite elaborate "regime TAARs" already exist in the tax legislation (e.g. the "loan relationship" rules in Parts 5 and 6 CTA 2009[954]; the "derivative contract" rules in Part 7 CTA 2009[955]; and the Finance Act 2011 bank levy rules[956]). These provide useful precedents which seek to ensure that the "main purpose" language of the TAAR does not prevent taxpayers making certain tax-efficient choices which are consistent with the policy of the relevant rules. Something similar could be developed in relation to entity classification. It could for example disallow (in whole or in part) an election where one of its "main purposes" was to create a mismatch resulting in unintended double non-taxation between jurisdictions and/or to share between taxpayers savings derived from a tax mismatch. There would therefore be some parallels between the last part of such a rule and the "structured arrangement" concept which is already used several times in Part 6A TIOPA (e.g. Section 259CA(7) and Section 259DA(7) TIOPA).

The HMRC hostility to elective entity classification is less easy to understand, because well-informed taxpayers already have significant freedom under the current rules to choose the desired UK tax

[953] There is a general problem with the way in which the UK courts have interpreted very expansively the "main purpose" form of words which is used in most TAARs: see Michael McGowan: "*HMRC v Lloyds Bank Leasing (No 1) Ltd*: the troublesome increase in the scope of the 'sole or main object' test" [2015] British Tax Review 649.
[954] See, in particular, Sections 455B-D CTA 2009.
[955] See, in particular, Sections 698B-D CTA 2009.
[956] See, in particular, paragraph 47 Schedule 19 Finance Act 2011, where some care is taken to ensure that the breadth of the anti-avoidance rule does not undermine activities and structures which reduce bank credit risk, even though those activities and structures also reduce the bank levy.

classification of their preferred entity, without altering its key commercial features. In particular, there are few substantive differences between a UK LLP and a UK private limited company. Both are quite easy for a taxpayer to set up. Yet the former is taxed as a partnership in most situations[957] while the latter is fully subject to corporation tax.

In relation to non-UK entities, HMRC have consistently taken the position that a US LLC should be regarded as a company for UK tax purposes (despite *Anson)*, while generally accepting that a US LLP is "tax transparent", on the basis that it is a partnership. Yet commercially, there is usually little substantive difference between US LLCs and US LLPs, not least in terms of the procedure for setting them up. Well-resourced and well-advised taxpayers can therefore already set up non-UK entities with a local law constitution, suitably tailored to achieve either an "opaque" or a "transparent" outcome under UK tax law[958], without altering the essential business structure. Hence the current UK system is "de facto" largely elective, but mainly for the benefit of those with the resources to obtain sophisticated professional advice.

Even if a modified elective classification system is a bridge too far, the existing rules could still be significantly improved. In particular, a less parochial approach is needed when classifying entities as "companies" versus "partnerships", bearing in mind that these concepts are meant to apply to entities formed under both UK and non-UK law. There is no necessary reason why a non-UK legal system will define a "partnership" in exactly the same way as English or Scottish law, with its central concept of a "business in common with a view of profit"[959]. Similarly, a non-UK legal system may well confer on a putative "partnership" a degree of legal personality which is more fully-fledged than the rather qualified concept of legal personality which applies to Scottish partnerships. For the reasons stated in *Ryall v The DuBois Company Limited*[960], the "partnership" concept needs to be interpreted more malleably. It would be better to focus above all on the role a type of entity fulfils (compared to other entities) under the commercial law of the relevant non-UK jurisdiction, when deciding if it is a "partnership", rather than trying to shoehorn it into UK concepts of "partnership" without reference to the local law context[961]. The fact that the entity has features (e.g. a more fully-fledged legal personality; creation of the entity by registration; and a need for a prior decision at entity level before distributing profits) which may be inconsistent with the English law "partnership" paradigm should not be the end of the story. This is especially true where civil law jurisdictions are concerned. Here narrower concepts of agency law have given rise to two different forms of arrangement with

[957] In limited situations, a UK LLP ceases to be taxed as a partnership and becomes subject to corporation tax. There have been cases where taxpayers have deliberately engineered such a change for avoidance purposes. Yet the relevant legislation still contains no TAAR to counter such strategies.
[958] In the immediate aftermath of *Anson,* a number of taxpayers looked closely at the structure of their US LLCs to ensure that they would continue to be regarded as "opaque" for UK tax purposes. This is of course HMRC's preferred classification of a US LLC.
[959] See Section 1 Partnership Act 1890.
[960] 16 TC 431.
[961] This alternative approach already applies in relation to "unilateral" foreign tax credit relief where, following *Yates v GCA International* [1991] STC 157, HMRC issued Statement of Practice SP7/91. In particular, when deciding whether a non-UK tax is an "income tax" for "unilateral relief" purposes, the answer "will be determined by examining the tax **within its legislative context in the foreign territory and deciding whether it serves the same function as income and corporation tax serve in the UK** in relation to the profits of the business" [emphasis added]. In making this statement, the UK tax authorities abandoned an earlier approach under which "…..the proportion of the gross amount charged to [non-UK] tax prompted the view that the [non-UK] tax could not reasonably be regarded as corresponding to UK income tax or corporation tax on net profits".

legitimate claims to be regarded as "partnerships": namely, formal and informal partnerships. There is no precise analogue for either in English partnership law, where the law of agency applies differently to partnerships. Yet that alone should not mean that these arrangements cannot be "partnerships" for UK tax purposes.

One area where UK tax legislation made moves in a less parochial direction some time ago relates to "settlements": these include more than common law trusts for both inheritance tax purposes[962] and for the purposes of the income tax and capital gains tax "settlement" rules[963] (but not for all income tax and capital gains tax purposes). Those broader definitions can therefore cover non-trust-based civil law arrangements such as foundations ("Stiftungen") which can have broadly similar wealth preservation and distribution effects to a trust, despite their structural differences.

More recently, there are limited signs of movement in terms of defining a "partnership" less narrowly for UK direct tax purposes. In Finance Act 2015, the UK enacted the "diverted profits tax" ("DPT"). This is a standalone tax, akin to corporation tax, on certain transactions aimed at eroding the UK corporation tax base either by creating mismatches of one sort or another, or by structuring UK business activity so that it avoids being a taxable "permanent establishment". For DPT purposes, a company is defined in accordance with Section 1121 CTA 2010[964]. However, this is supplemented by a non-exhaustive definition of "partnership" which reads[965]:

> '"Partnership" includes (a) a limited liability partnership to which section 1273 of CTA 2009 applies [i.e. a UK LLP], and (b) **an entity established under the law of a territory outside the United Kingdom of a similar character to a partnership** [emphasis added], and "member" of a partnership is to be read accordingly'.

"Of a similar character" clearly invites a court, in a DPT context, to interpret "partnership" in a manner which does not cling too closely to the English law paradigm. This makes complete sense because DPT is most likely to apply to cross-border arrangements.

8.6.2 *"Tax transparency": how far should it apply to partnerships?*

The UK approach to classifying entities (and in particular non-UK entities) could therefore be simplified and improved, without triggering major avoidance. It could also be modified so as to strengthen the UK tax base. However, that is not the end of the story. In particular, the fact that an entity is classified so that it is prima facie "tax transparent" need not lead to such treatment in all situations. "Transparency" is a tax policy choice. In the past, such choices have not always been made in a manner which reflects underlying economic reality, and the different strands of the "transparency" concept have evolved piecemeal.

The "tax transparency" of partnerships is an especially good example of this. The classic UK position is that if an entity is a "partnership", then it enjoys a high degree of tax transparency, especially when taxing its income and gains. In particular, these are taxed at partner level only, on the basis that each partner (however lowly and wherever located) has a direct entitlement for tax purposes to the

[962] Section 43(2) IHTA.
[963] In Part 5 Chapter 5 ITTOIA, and especially Section 620(1) ITTOIA.
[964] Section 114(1) FA 2015.
[965] Section 114(1) FA 2015.

underlying assets and income sources of the partnership. A similar approach applies in respect of partnership losses. Furthermore, an individual partner in a partnership is regarded in all cases as self-employed. Hence that partner is subject to a significantly lower National Insurance liability than an employee or director of a company who enjoys similar status.

This largely all-or-nothing transparency approach to "partnerships" again overlooks the increasingly strong commercial similarities between limited liability partnerships on the one hand and private limited companies on the other[966]. LLPs are now of course commonplace, especially where the "partnership" is engaged in active business (notably professional and financial services). General services partnerships where partners retain unlimited liability for the firm's obligations are now the exception rather than the rule in these sectors[967]. Is it appropriate that the tax treatment of a member of a LLP[968] should always differ so radically from that of a senior shareholder-employee or director of a limited company, when there are few significant commercial distinctions between these two types of entity?

Not least because of the UK approach to "transparency", partnership structures are routinely used to remunerate UK-resident high-earning individuals[969] at abnormally low effective tax rates, even where their role mainly involves providing services in the UK to clients of the partnership. Partners in a partnership pay National Insurance at lower rates than similarly-remunerated employees, and there is no equivalent for partners of the separate employer's National Insurance liability[970]. Furthermore, where the partnership is managed outside the UK despite carrying on part of its business in the UK, the fact that it is "tax transparent" gives considerable scope to allocate non-UK-source partnership income to UK-resident, but non-UK-domiciled partners. They are then typically taxed on those income allocations on the much more generous "remittance" basis (i.e. if and when those profits are directly or indirectly repatriated to the UK). The "remittance" basis is available whether or not those profits have been subject to significant non-UK taxation. The result is often very low effective taxation on income which is technically "non-UK source" (because of the "transparency" fiction) but which, in

[966] The UK courts have been slow to adjust their thinking to reflect evolving business realities in relation to so-called "partnerships". For example, in *MacKinlay v Arthur Young McLelland Moores & Co* [1989] STC 898, the House of Lords overturned the Court of Appeal's decision in favour of the taxpayer. Lord Oliver said at pages 903-4, "…I am unable to accept that the purpose of 'the partnership', considered as if it has a separate legal identity, and the purpose of the individual partners for whose benefit the payment [of business-related removal expenses] enured can be segregated in this way….[T]he Court of Appeal…..appear to have been influenced by the sheer size of the partnership [which was a large nationwide firm of accountants] ….and to have considered that a large partnership falls in some way to be treated differently from a small partnership….Partners are partners, however numerous; and mere numbers cannot in itself justify an attribution of a 'collective purpose' unjustified in the case of a small partnership." This case regarding the relationship between a large nationwide accounting partnership and its partners predated the advent of LLPs, but it was the emergence of such large, centrally-managed partnerships which was the catalyst for LLPs.
[967] The famous London law firm, Slaughter & May, appears to be a rare enduring example of a major English law general partnership.
[968] The introduction in 2000 of the UK LLP vehicle followed intensive lobbying by, in particular, the accounting profession for an entity where the liability of members involved in firm management could be limited but which nevertheless was "transparent", not "opaque", for UK direct tax and National Insurance purposes.
[969] Especially where the partnership is a non-UK-managed partnership with significant non-UK income and the partner is non-UK-domiciled. There is a separate question, beyond the scope of this thesis, about whether some of these partnerships really are managed outside the UK.
[970] This 13.8% liability on all employee remuneration is a very significant extra tax cost for employers, even though the employer can deduct it for income tax/corporation tax purposes.

reality, is usually being paid to UK-resident partners for rendering services in the UK to clients. Were those individuals receiving that remuneration from a non-UK company (e.g. a bank) carrying on business in the UK, then they would probably be subject to UK employee income tax on an arising basis, as well as employer and employee National Insurance contributions, on the basis that they were employees performing UK services[971]. The latter analysis better reflects economic reality. Hence, it is hard to justify a radical difference in individual tax treatment because an individual is a partner in a "transparent" partnership, especially when the difference between partnerships and companies is increasingly hard to pin down.

Some would argue that there is a fundamental difference between the status of partner and the status of employee, because the former, but not the latter, is an entrepreneur. Hence the difference in tax treatment described above. However, this argument is not strong, especially when partners are being compared with senior employees. LLPs are now very widespread. LLP status ensures that "partners" typically bear levels of liability for the LLP's obligations which do not differ significantly from those which a senior employee, with a large holding of incentive shares in its employer, would bear in relation to that employer company. Indeed in industries such as financial services, regulatory changes have significantly increased the risk to senior employees of various financial and other sanctions, including possible remuneration "clawback". It is also standard practice for such senior employees' significant shareholdings in their employers to be "locked in" over an extended period, just as partners contribute long-term capital to a partnership. Hence a partner in a LLP and a senior employee of a company performing similar roles may nowadays be exposed to very similar business and legal liability risks. Both are typically remunerated mainly on a performance-related basis: while partners are technically remunerated with a share of profits, that share, like a senior employee's remuneration, will usually be heavily tied to prescribed individual performance targets. A centralised management committee of the LLP or the employing company is likely to have very wide discretion to fix that remuneration. Indeed management centralisation is now the norm in major partnerships (e.g. law firms and accounting firms). Such management is typically secretive and it is ever rarer for major decisions to be put to a meaningful partnership vote.

Hence the effective status of most partners within major partnerships is akin to that of senior company employees on performance-related pay packages. It is therefore highly anomalous that the tax classification of a business entity, as a "transparent" partnership rather than a company, should often lead to much more favourable tax treatment for relevant senior staff than if they were formally employees. As a matter of tax policy, a more level playing field is appropriate, in order to reflect economic reality better, even if the basic principle that the partnership is "transparent" for tax purposes is respected.

Recent legislation has tried to correct some distortions which can arise if the "tax transparency" which typically flows from classifying an entity as a partnership is applied too widely. In particular, the "salaried member" legislation introduced in 2014[972] treats certain members of a UK LLP on relatively

[971] Being non-UK-domiciled is much less likely to change this materially, because the "remittance" basis is less readily available in respect of the income of employees.
[972] See now Sections 863A-G ITTOIA. Even before this legislation was introduced, there was debate about whether a member of a UK LLP could ever be its employee, but mainly in relation to employment law, not tax law. This debate centred on the obscure Section 4(4) Limited Liability Partnerships Act 2000. It may well be irrelevant for tax purposes because, subject to the "salaried member" rules, UK LLP members are **deemed** to carry on the LLP's business as partners for tax purposes: see Section 863 ITTOIA and the First-Tier Tribunal in

fixed remuneration, and with a relatively small say in the running of the LLP, as if they were in fact employees, not partners, for income tax and National Insurance purposes. This change (which better reflects the real economic and management status of many LLP members) was hotly contested when introduced but partially addresses the distortions described above. However, its impact is limited. It does not in particular apply to non-UK LLPs, a number of which are very active, and very successful, in the UK. If the playing field is to be levelled in the manner suggested above, there is much more to be done.

Very similar points can be made about the UK taxation of "carried interest". This is a complex topic which can only be discussed here in summary. "Carried interest" is a method of paying what are in effect performance-related fees to fund managers (e.g. in the hedge fund and "private equity" industries). The fee entitlement (if any) can be very large. It is typically structured as a special partnership interest. Because partnerships are "transparent" for income tax and capital gains tax purposes, it is therefore regarded as an interest in underlying investments of the fund which is being managed. One aim has been to characterise as much as possible of the profits from that special partnership interest as capital gain from those underlying managed assets, so that the recipient can access much lower effective tax rates than if the profits were simply treated as fee income for management services. An alternative aim may be for "carry" to be treated as derived from underlying non-UK-source income of a partnership, so that a non-UK-domiciled recipient can pay UK tax only on the "remittance" basis.

Yet the underlying economic reality is that "carry" is fee income for providing services. Moreover, this is the basis on which it would probably be taxed if, instead, it were simply paid by a fund manager which was a company (e.g. an investment bank), to a fund manager which was an employee. Therefore, the use of "transparent" partnerships to create "carry" structures lies at the root of unequal (and highly favourable) taxation of such profits. In 2015-6, the UK enacted legislation[973] cutting back significantly the tax privileges of "carried interest", without denying the basic "transparency" of the partnerships in question. That legislation is a step in the right direction, not least because it limits the entitlement to capital gains tax treatment on such profits. However, it is complex, not least because it does not fully reverse the unequal tax treatment referred to above. There is already evidence of considerable planning activity to circumvent the 2015-6 changes.[974].

Peter Wilson v HMRC [2020] UKFTT 230 (TC). The judge in that case also ruled (obiter) that, because of Section 4(4), a member of an English law UK LLP could not be its employee for any purpose, following dicta of Lady Hale in the Supreme Court in an employment law case, *Clyde & Co v Bates van Winkelhof* [2014] 1 WLR 2047. Lady Hale disagreed with the Court of Appeal's previous reading of Section 4(4) in *Tiffin v Lester Aldridge LLP* [2012] IRLR 391. It is odd that the Supreme Court's reading of Section 4(4) now distinguishes between English and Scottish LLPs. The LLP is a new UK-wide corporate vehicle. Its legal treatment should, where possible, not be coloured by any historical differences between England and Scotland about whether a general partnership can employ one of its members (see also fn 51). The courts' conclusion also leaves English partnerships and LLPs in a different position compared to non-UK LLPs operating in the UK. As the latter typically have legal personality and are unaffected by Section 4(4), it is far from clear why their members cannot in suitable cases be employees of the non-UK LLP. Such non-UK LLPs are of course unaffected by the tax fictions in Sections 863 or 863A-G ITTOIA.

[973] See Sections 103KA-KH TCGA and Sections 809EZA-FZZ ITA.

[974] Although the UK rules go further than the much more modest limits on "long-term capital gain" treatment of "carried interest" in the US Tax Cuts and Jobs Act 2017, discussed in 7.2.

If changes are required to better reflect the increasingly narrow difference between a LLP and a company, the law should also make it clearer that an affiliation between two companies can be traced through a partnership or a LLP. It should also make it clearer how this is to be achieved, given the nature of a partnership. In particular, rules are needed similar to those permitting one company to establish its indirect "beneficial ownership" of ordinary share capital in another company, by tracing ownership through one or more intermediate companies[975].

8.6.3 *"Tax transparency": trusts*

In relation to partnerships, the concept of "tax transparency" has been applied rather too generously for UK tax purposes, especially as the commercial differences between companies and partnerships have been steadily eroded. It has also been applied somewhat inconsistently, because "transparency" does not mean the same thing in relation to income tax as compared to capital gains tax (see Appendix A). It has yet another different meaning in relation to SDLT: see 5.7.

By contrast, "tax transparency" has been applied more restrictively to UK trusts, especially since the IHT changes in 2006. Hence more situations give rise to economic double taxation i.e. taxation at the level of UK-taxpaying beneficiaries or settlors on distributed or undistributed trust income, gains and assets, without a full offset or refund for tax borne at the level of the UK trust. The reasons for this have not always been clearly articulated and it is unsatisfactory that holding assets via UK trusts often carries a significant extra tax cost when compared to owning those assets directly. Trusts have of course been used in the past for tax planning. However the pendulum has now swung too far the other way, given the legitimate non-tax reasons for keeping assets in trusts (notably, to protect assets and/or vulnerable or minor beneficiaries).

"Bare trusts" aside, the only clear situation in which a beneficiary of a trust enjoys clear "look through" treatment for income tax purposes is under the rule in *Baker v Archer-Shee.* The oddities of this rule have already been explored in 4.3.3.2. It does of course mean that a beneficiary with a vested interest in possession can be taxed on both distributed and undistributed trust income. By contrast, it is sensible that beneficiaries under a discretionary trust are not taxed on undistributed trust income on a fully "transparent" basis, because they may never be entitled to that income. It is also sensible that the trust, if UK-resident, is taxable on that income because otherwise there would be significant scope for deferral by allowing income to build up in the trust. However, when discretionary beneficiaries do receive income from a UK-resident trust, there is a flawed mechanism for linking that income to the underlying income sources of the trust. This can lead to inefficiencies, including economic double taxation as well as the beneficiary being unable to access preferential tax rates on distributions of certain types of underlying income (e.g. dividends). These weaknesses are alleviated, but only in part, by concession and statute[976].

For capital gains tax purposes, unless a UK-resident trust is a Section 60 TCGA "bare trust", then it is a taxable entity in its own right, and not merely on a "representative" basis[977]. Hence economic double taxation can arise, once at the level of the trust and again at the level of the beneficiaries. To give an example, the disposal of a beneficial interest in a non-"bare" trust is not always exempt from tax on

[975] See Part 24 Chapter 3 CTA 2010.
[976] ESC B18 and Section 111 TIOPA.
[977] This means that its tax liability is largely unaffected by the tax status and attributes of its beneficiaries.

chargeable gains[978]. This is harsh bearing in mind that a trust is a mechanism for segregating, safeguarding and managing assets on behalf of beneficiaries. In particular, the tax result if assets are held in trust is not harsher compared to what it would be if beneficiaries owned those assets directly. Unsurprisingly, such rules are an incentive to set up trusts outside the UK in low-tax jurisdictions: this largely eliminates UK tax at the level of the trust, unless the non-UK-resident trustees dispose directly or indirectly of UK real property[979].

As for inheritance tax, changes in 2006 have ensured that far more "settlements" are taxable under the UK's highly unusual "relevant property" regime[980]. Inheritance tax is then computed and charged on the settlement on a largely standalone basis which takes very little account of the inheritance tax status of the trust beneficiaries and of any reliefs to which they may be entitled[981]. The result is likely to be more onerous taxation than if the assets were held directly by the trust beneficiaries. In the latter case, headline inheritance tax rates would be higher but available reliefs would be more generous (notably the "potentially exempt transfer" and the exemption for transfer between spouses).

There is one type of UK trust where these economic double taxation problems are less pronounced. This is the UK "authorised" unit trust, a standard collective investment vehicle, interests in which can be marketed to retail investors. Economic double taxation must be eradicated for such a vehicle to be viable. This is not achieved by making it "tax transparent" in the UK on a pure "look through" basis. Instead the trust is treated as a company for UK tax purposes but enjoys certain entity-level exemptions from tax on income and gain, provided that it does not engage in trading activity (which is unlikely). Normally there is taxation only at investor level on distributions[982]and there is scope for these to be characterised, for UK tax purposes, in the same way as the fund's underlying income. Investors' holdings are treated as shares in a company. Hence there is no "look through" to the underlying assets of the unit trust[983]. Because there is no "look through", investors cannot claim relief for any non-UK tax on the income and gains of the unit trust. Also the losses of the trust (if any) are not investors' losses for tax purposes, although they will no doubt be reflected in the value of investors' units.

8.6.4 *"Tax transparency": conclusion*

Even if an entity is classified in a way which typically lends itself to "tax transparency"[984], the precise consequences of that transparent treatment need careful consideration. Judging how far the concept of "transparency" should be allowed to run, and the form it should take, is at least as important as deciding how to classify an entity or arrangement in the first place. In the past, the classification question has absorbed much judicial and practitioner time and energy, not least because of the weaknesses of the UK entity classification rules. Those rules need a thorough overhaul and some

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[978] Under Section 76 TCGA but see also Section 76A and Schedule 4A TCGA.
[979] One also needs to take account of the various anti-deferral rules for taxing UK-resident settlors and beneficiaries on the undistributed gains of a non-UK trust: see Sections 86-98A TCGA.
[980] Part III Chapter III IHTA.
[981] HMRC saw the 2006 changes as a means of addressing abuse of the potentially more generous rules in Part III Chapter II IHTA. In the limited cases where they remain applicable, those rules still produce a tax outcome which is closer to what would apply if the beneficiaries owned the trust assets directly.
[982] Where income is undistributed, investors can be taxed on deemed distributions so as to avoid tax deferral.
[983] This simplifies investor tax compliance, when they dispose of interests in the trust.
[984] Whatever that means in the particular context.

suggestions have been made about how best to achieve this e.g. along the lines of a restricted entity classification election.

However, the tax policy consequences of classifying entities in certain ways need as much scrutiny, especially where "tax transparency" is the expected outcome of a particular classification. Currently, well-advised taxpayers retain too much scope to use, in particular, partnerships to achieve very low effective taxation. By contrast, the UK taxation of trusts and equivalent wealth protection mechanisms needs to move towards a more broadly applicable, but modified version of "transparency". In particular, this would ensure that trust income and gain is taxed in a way which better reflects the source of the trust's underlying profits and the tax profile of its beneficiaries.

Appendix A: UK capital gains tax "transparency" of partnerships and LLPs and its wider implications

A.1 *Introduction*

No discussion of "tax transparency" in UK law can ignore the capital gains tax rules applying to partnerships and UK LLPs. These rules are mainly in Sections 59-59A TCGA. Their approach is broadly similar to the treatment of "bare trusts" in Section 60 TCGA, but their approach is not identical.

A.2 *Section 59 TCGA*: *partnerships*

This reads:

> "(1) Where 2 or more persons carry on a trade or business in partnership –
> (a) tax in respect of chargeable gains accruing to them on the disposal of any partnership assets shall, in Scotland as well as elsewhere in the United Kingdom, be assessed and charged on them separately, and
> (b) any **partnership dealings** [emphasis added] shall be treated as **dealings by the partners** and not by the firm as such…
> (c) …
> (2) Subsection (3) applies if –
> (a) a person resident in the United Kingdom ("the resident partner") is a member of a partnership which resides outside the United Kingdom or which carries on any trade, profession or business the control and management of which is situated outside the United Kingdom, and
> (b) by virtue of any arrangements that have effect under section 2(1) of TIOPA, ('the arrangements') any of the chargeable gains of the partnership are relieved from capital gains tax or corporation tax in the United Kingdom.
> (3) The arrangements (so far as providing for that relief) do not affect any liability to capital gains tax (or corporation tax) in respect of the resident partner's share of any chargeable gains of the partnership.
> (4) For the purposes of subsections (2) and (3) the members of a partnership include any person entitled to a share of chargeable gains of the partnership."

Subsections (2) – (4) are the UK override, for the purposes of taxing capital gains, of *Padmore v IRC,* discussed in 6.2.2. Of greater importance is Section 59(1). This makes clear that if the partnership (including a Scottish partnership and a non-UK partnership) disposes of any of its assets, the partners are to be separately assessed in respect of gains "accruing to them". No further detail is provided on how the gains accruing to each partner in this way are to be quantified. Nor is "partnership" defined.

The ambit of Section 59(1)(b) is debateable. Read narrowly, it simply says that if the partnership itself deals with its assets, then that dealing is treated as being carried out by the partners themselves and not by the firm (which may or may not be a separate legal person). In short, the partnership is "looked through" but only where the partnership itself deals with its assets. This narrow reading means that Section 59(1)(b) adds very little to Section 59(1)(a). It also risks creating a "look through" rule under Section 59(1) whose effect is narrower than the equivalent rule for UK LLPs in Section 59A, which is discussed below. That would be a strange and unintended outcome. Hence "partnership dealings" should be given a broader meaning so that it means "dealings in connection with the partnership". Section 59(1)(b) would then cover (i) an asset acquisition or disposal by the partnership, and (ii) a partner's acquisition or disposal of its partnership rights, even if there were no concurrent acquisition or disposal of underlying assets by the partnership. This reading would make clearer that, under Section 59, the partner's interest in the partnership is not a separate and distinct asset for the purposes of taxing capital gains,

Even if this broader reading is correct, Section 59(1) does not "look through" the partnership so as to treat partners as simple co-owners of the underlying assets. The phrase "dealings by the partners" indicates that the partnership is not simply disregarded and its members are treated as dealing with partnership assets as partnership property. A partner's interest in partnership property is a special kind of proprietary interest even if the partnership lacks legal personality. It should not be equated with simple co-ownership (see 5.2).

A.3 *Section 59A TCGA: UK limited liability partnerships*

This Section was inserted long after Section 59 to deal with the taxation of UK LLPs. It provides for when a UK LLP is to be "looked through" for the purposes of taxing chargeable gains. Where it operates, the UK tax authorities expect the outcome for UK LLPs to correspond to that for partnerships under Section 59. This is sensible but Section 59A is worded differently from Section 59. In particular, it states:

> "(1) Where a limited liability partnership carries on a trade or business with a view to profit –
> (a) **assets held by the limited liability partnership are treated for the purposes of tax in respect of chargeable gains as held by its members as partners**, and
> (b) **any dealings by the limited liability partnership are treated for those purposes as dealings by its members in partnership** (and not by the limited liability partnership as such) [emphasis added];
>
> and tax in respect of any chargeable gains accruing to the members of the limited liability partnership on the disposal of any of its assets shall be assessed and charged on them separately.
>
> (2) For all purposes, except as otherwise provided, in the enactments relating to tax in respect of chargeable gains –
>
> (a) references to a partnership include a limited liability partnership in relation to which subsection (1) above applies,
>
> (b) references to members of a partnership include members of such a limited liability partnership,

(c) references to a company do not include such a limited liability partnership, and
(d) references to members of a company do not include members of such a limited liability partnership.
(3) Subsection (1) above continues to apply in relation to a limited liability partnership which no longer carries on any trade or business with a view to profit –
(a) if the cessation is only temporary, or
(b) during a period of winding up following a permanent cessation, provided –
(i) the winding up is not for reasons connected in whole or in part with the avoidance of tax, and
(ii) the period of winding up is not unreasonably prolonged, but subject to subsection (4) below.
(4) Subsection (1) above ceases to apply in relation to a limited liability partnership –
(a) on the appointment of a liquidator or (if earlier) the making of a winding-up order by the court, or
(b) on the occurrence of any event under the law of a country or territory outside the United Kingdom corresponding to an event specified in paragraph (a) above.
(5) **Where subsection (1) above ceases to apply in relation to a limited liability partnership with the effect that tax is assessed and charged** –
(a) on the limited liability partnership (as a company) in respect of chargeable gains accruing on the disposal of any of its assets, and
(b) **on the members in respect of chargeable gains accruing on the disposal of any of their capital interests in the limited liability partnership** [emphasis added],
it shall be assessed and charged on the limited liability partnership as if subsection (1) had never applied to it.
(6) Neither the commencement of the application of subsection (1) above nor the cessation of its application in relation to a limited liability partnership shall be taken as giving rise to the disposal of any assets by it or any of its members".

The last two lines of Section 59A(1) are very similar to Section 59(1)(a) in relation to partnerships. Section 59A(1) does not use the concept of "partnership dealings" which appears in Section 59(1). Instead, Section 59A(1)(b) treats dealings by the limited partnership entity itself (e.g. the acquisition or disposal of assets by that entity) as if they had been carried out by the LLP members. It is not possible to give Section 59A(1)(b) the wider interpretation suggested above for "partnership dealings" in Section 59(1).

Hence Section 59A(1)(b) does not cover the disposal of a member's interest in the LLP. However, that leaves Section 59A(1)(a), which has no equivalent in Section 59. Section 59A(1)(a) applies a form of "look through": the LLP's members are treated as holding its assets directly, but as partners rather than simple co-owners. Hence, Section 59A(1)(a) treats the LLP's members as having the special kind of proprietary interest (see 5.2) which partners in an English general partnership have in partnership property. Therefore, Section 59A(1) does not treat LLP members as part-owning particular LLP assets in simple percentage shares. Both it and Section 59 differ from Section 60 TCGA, which does operate on the basis of co-ownership and where the nature of a partner's interest in partnership property is irrelevant.

Consequently, when taxing chargeable gains, a member's interest in a UK LLP seems to be disregarded as a separate asset from the underlying assets of the LLP. The member is deemed to part-own these as a partner under Section 59A(1)(a). This is obliquely confirmed by Section 59A(3)-(6) which dictate when and how the "look through" in Section 59A(1) ceases to apply. In particular, Section 59A(5)(b) indicates that, once Section 59A(1) ceases to apply, each member's "capital interest" in the LLP (a concept not mentioned until then) becomes a separate capital asset for tax purposes. That is logical because once Section 59A(1)(a) ceases to apply, the tax fiction that it is a partnership, not a company, falls away retroactively.

A.4 *Statement of Practice D12 ("SP D12")*

Therefore, Sections 59-59A apply a qualified form of "transparency" to partnerships and UK LLPs but fail to spell out in full what this entails. In practice, much of the gap has been filled by a long-standing Statement of Practice, SP D12, which has been updated in recent years, not least to accomodate Section 59A. Important parts of SP D12 go beyond anything that Sections 59-59A can clearly justify. Usually, SP D12 has tended to benefit taxpayers but, at last in theory, a taxpayer could seek to be taxed on the strict letter of Sections 59-59A, ignoring SP D12[985].

SP D12 is too detailed to be analysed in its entirety here. However, it, and the associated HMRC guidance, operate much more explicitly on the basis that partners have fractional co-ownership interests in the assets of the partnership. Its second paragraph states: "[Section 59A(1) TCGA] complements [Section 59(1) TCGA] in treating any dealings in chargeable assets by a limited liability partnership as dealings by the individual members, as partners, for CGT purposes. **Each member of a limited liability partnership to which [Section 59A(1)] applies has therefore to be regarded, like a partner in any other (non-corporate) partnership, as owning a fractional share of each of the partnership assets and not an interest in the partnership itself**". This highlighted sentence significantly expands what Section 59(1) and Section 59A(1) actually say, as does the following sentence at CG27150 of the related HMRC guidance: "The effect of the rules [i.e. Sections 59-59A] is that there is a disposal for [capital gains tax] purposes when either (i) the partnership disposes of an asset or (ii) one or more of the partners' fractional interests in a partnership asset is/are reduced".

Section 1 of SP D12 invents a special valuation rule for a partner's fractional interest in a partnership asset. In particular, that value is a fraction of the value of the partnership's entire interest in that asset, **without any discount for the size of the partner's interest**. Furthermore, Section 2 of SP D12 provides non-statutory guidance on how to measure a partner's fractional interest in an asset. The first port of call is (any) explicit statement, at the relevant time, about the partner's entitlement to share in asset surpluses. Failing that, one looks to the actual destination of such asset surpluses, as shown in the partnership accounts and any related agreement. If asset surpluses are not allocated as such among partners, one looks to the partnership's ordinary profit-sharing ratio.

Importantly, SP D12 sets out how the partners are to be taxed when there are adjustments in partnership sharing ratios. This will include when partners leave and join the partnership. The aim is to minimise the risk that such adjustments (which are usually entirely commercial) trigger unfunded tax charges because Sections 59-59A deem part-disposals of underlying partnership assets to arise because sharing ratios are being adjusted. Paragraph 4.1 of SP D12 states:

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[985] It has been suggested that SP D12 should be enacted as legislation: see Simon Yates: "Partnerships and Capital Gains" [2008] BTR 587 at 610. SP D12 has yet to be turned into legislation and if it were, it would need to be backstopped by a "targeted anti-avoidance rule" to discourage the kind of tax planning for which it has been used in the past. There is further extensive guidance, with examples, on SP D12 in HMRC's Capital Gains Manual at CG27150 to CG28420 (accessed May 2020).

> "In these circumstances, a partner who reduces or gives up his share in asset surpluses will be treated as disposing of part or the whole of his share in each of the partnership assets and a partner who increases his share will be treated as making a similar acquisition. Subject to [certain important exceptions, which are not considered further here], the disposal consideration will be a fraction (equal to the fractional share changing hands) of the current balance sheet value of each chargeable asset provided there is no direct payment of consideration outside the partnership".

Where that current balance sheet value equals the tax base cost in that underlying asset, there should therefore be no chargeable gain or allowable loss when sharing ratios change. A "dry" (i.e. unfunded) tax charge is thereby avoided: see paragraph 4.2 of SP D12, which sets out further situations where this "no gain no loss" approach will not apply.

Where a new partner makes a capital contribution to the partnership which is credited to that partner's current or capital account, that contribution is **not** treated under SP D12 as the acquisition cost of a fractional interest in partnership assets. Nor is it treated as consideration received by existing partners for reducing their fractional interests in partnership assets, in favour of the new partner. Similarly, merely repaying a retiring partner's capital account is not automatically treated as direct consideration paid to that partner for disposing of its fractional interest in partnership assets. This treatment is effectively concessionary.

Paragraph 4.2 focusses on the current balance sheet value of partnership assets. Hence it does not prevent a "dry" tax charge where a partner contributes a chargeable asset (i.e. not Sterling) in return for a partnership share or an increased partnership share: see Section 5 of SP D12. In that case, the contributing partner has made a part-disposal of the contributed asset equal to the fraction of it that passes to the other partners. Depending on the circumstances, that fractional interest will be treated as disposed of (i) for its market value; or (ii) for the amount given in return by the other partners, in the form of fractional interests in the partnership's other assets.

Section 5 does not address whether, when partners contribute assets to a partnership and receive a proportionate partnership share in return, disposals on making those contribution can be avoided using the "pooling" analysis in *Booth v Ellard*[986] and *Jenkins v Brown*[987] (see 4.3.2.2). Equally, neither Section 3 nor Section 5 addresses whether those cases prevent a disposal by any partner when a partner withdraws assets "in specie" from the partnership in proportion to its partnership share. Indeed Section 3 ("Partnership assets divided in kind among the partners") seems inconsistent with the courts' approach in those cases[988]. To date, the point has not been tested in litigation.

The SP D12 approach to the "transparency" of a partnership is cumbersome and compliance-intensive, not least because it entails a fairly radical "look through" to underlying partnership assets. It will require an adequate supply of information from the partnership to each partner about underlying assets, base costs and relevant balance sheet information. In particular, it requires each partner to identify and keep track of its fractional interests in each of the partnership's capital assets, as well as its separate base costs in each of those fractional interests. These variables will change over time as

[986] [1980] STC 555 upholding [1978] STC 487.
[987] [1989] STC 577.
[988] Section 3 assumes that each partner who is not receiving the asset in kind disposes of a fractional interest in that asset to the partner who is receiving it. If that analysis is correct, it may still be possible to postpone tax using Section 165 TCGA holdover relief, if the partners agree.

the partnership acquires and disposes of assets; and/or partners' sharing ratios change. Under SP D12, a partner cannot assume that its base cost in a particular fractional interest is simply the amount given by the partnership for the underlying asset, multiplied by that partner's percentage partnership share. Hence the SP D12 approach is best suited to partnerships with a limited and fairly static membership, as well as limited changes in sharing ratios.

A.5 *Schedule 7AD TCGA*

Because Sections 59-59A (coupled with SP D12) are cumbersome, UK tax law has in one area adopted a less radical transparency approach when taxing partnership capital gains. In summary, Schedule 7AD TCGA applies where, for the purposes of an insurance company's "long-term" insurance business, it is a limited partner in a "venture capital investment partnership"[989], which need not be a UK partnership but which must usually hold unquoted shares and securities. In that case, Section 59 TCGA is largely disapplied and the insurance company's partnership interest "is treated as a single asset"[990]. In other words, the partnership interest is not "looked through" and treated as a bundle of fractional interests in underlying partnership assets. Moreover, the insurance company can acquire a tax base cost in that single asset[991]. The insurance company is treated as part-disposing of that single asset (and not the underlying partnership assets) each time it receives a distribution in respect of underlying securities disposed of by the partnership. It can offset part of its base cost in the single asset when computing gain or loss on that part-disposal. If the partnership does not actually make a distribution in respect of securities of which it disposes, within one year of their disposal, then the insurance company is treated as having received its pro rata share of the amount received by the partnership for those securities. In this way, it is taxed on both distributed and undistributed gains of the partnership, with limited scope for deferral. Schedule 7AD therefore achieves tax transparency in respect of the underlying gains of the limited partnership without fully "looking through" the limited partner's interest to the underlying partnership assets.

This tax transparency is partial. In particular, if the insurance company sells its interest in the limited partnership to a third party, then it is treated as disposing only of its partnership interest, which is regarded as a separate asset under Schedule 7AD. It is not treated as part-disposing of each of the underlying securities held by the partnership, which would be the approach of Sections 59 and 59A, in conjunction with SP D12. Equally, if the partnership disposes of assets at a loss, a share of those capital losses does not flow directly to the insurance company partner, although the loss may be reflected in the value of the partnership interest.

A.6 *"Authorised contractual schemes" and "offshore funds"*

A somewhat similar approach to Schedule 7AD has been adopted recently in relation to two types of investment fund (one UK, one non-UK) which are billed as "tax transparent" for UK tax purposes. The first of these is an "authorised contractual scheme"[992] where it takes the form of a contract-based

[989] As defined in paragraph 2 Schedule 7AD. See also HMRC Life Insurance Manual at LAM03600 to LAM03650 (accessed April 2020).
[990] Paragraph 3(2)(a) Schedule 7AD.
[991] Paragraph 4 Schedule 7AD. This is what US tax advisers refer to as an "outside basis", to distinguish it from the partnership's own base cost ("inside basis") in partnership assets.
[992] See Section 237(3) FSMA.

“co-ownership scheme”.[993] “Authorised contractual schemes” were introduced in order to provide a tax-“transparent” competitor to entities such as the Luxembourg “fonds commun de placement”. They are expressly excluded, whatever form they take, from the definition of a “company” in Section 1121 CTA 2010. The second type of investment fund referred to above is a so-called “offshore fund” (e.g. a non-UK-resident unit trust scheme) which is regarded as “transparent” for UK income tax purposes[994].

In either of these cases, the new Section 103D(3) TCGA spells out that “A unit in a tax transparent fund is treated as an asset for the purposes of [TCGA] and, accordingly, a participant’s interest in the fund property is disregarded for those purposes”. Section 103D(5)-(9) makes various adjustments to reflect the treatment of the fund unit as a separate asset under TCGA. In particular, amounts chargeable to income tax on the unit holder (because unit holders are entitled to underlying fund income as beneficial co-owners) can be added to that holder’s base cost in the unit when computing gains on disposing of the unit. This avoids economic double-taxation on the unit holder’s share of the fund’s undistributed income (whose retention is likely to boost the value of units)[995].

Where Section 103D applies to an “authorised” contractual co-ownership scheme which owns an interest in UK land, units in it will be treated not just as assets but as shares in a company[996] for the purposes of taxing non-UK-resident investors on chargeable gains where they dispose of assets deriving at least 75% of their value from UK land[997].

Oddly, Section 103D does not replicate those features of Schedule 7AD which ensure that treating an interest in the fund as a separate asset does not lead to significant deferred tax on undistributed gains of the fund.

A.7 *Limits on the transparency of partnerships and LLPs when taxing chargeable gains*

While SP D12 provides practical clarification on how to apply Sections 59-59A, there are key issues which it does not address at all, or only obliquely. In particular, to what extent can one use these

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[993] See Section 235A(2)-(4) FSMA. Scheme participants must beneficially co-own its assets as tenants in common, with the property being held on trust for them by a depositary. An “authorised contractual scheme” can be set up, alternatively, as a limited partnership (see Section 235A (5)-(7)), in which case UK taxation of partners’ chargeable gains will depend upon Sections 59-59A TCGA.
[994] See the definition of “transparent fund” in Regulation 11 Offshore Fund (Tax) Regulations 2009 SI 2009/3001. That definition turns on whether an interest in the fund would entitle its holder to underlying fund income as it arises, as per *Baker v Archer –Shee* 11 TC 749.
[995] Section 103D(3) in fact suggests that distributed, taxed fund income can also be added to the unit holder’s base cost. This is illogical because there should be no economic double taxation of such non-retained fund income, if its distribution is fairly prompt.
[996] See paragraph 5 Schedule 5AAA TCGA.
[997] For these purposes, an asset can only derive at least 75% of its value from UK land if “the asset consists of a right or an interest in a **company** [emphasis added]” and at least 75% of the value of specified assets of that company derives directly or indirectly from interests in UK land: see paragraph 3 Schedule 1A TCGA. Hence non-UK-residents investing in UK land via a “company” are only subject to tax on chargeable gains if this “75% of value” test is met. By contrast, non-UK-residents investing in UK land via a partnership or UK LLP are subject to tax on gains even if less than 75% of the partnership’s asset value is derived from UK land, because of Sections 59-59A TCGA. This places investment by non-UK-residents in UK land via “companies” (including an “authorised” contractual co-ownership scheme) at a significant advantage over such investment via a partnership.

sections to "look through" a partnership or a UK LLP, so that a group relationship can be established between a corporate member of the partnership/LLP and a company whose shares are held by that partnership/LLP?

Suppose that Company A holds a 75% interest in a partnership or UK LLP which in turn holds directly all the ordinary shares of Company B. Are Company A and Company B "grouped" for the purposes of corporation tax on chargeable gains, according to Section 170 TCGA?

The practical answer should be "yes" and this is what HMRC published guidance appears to confirm, in the Capital Gains Manual at CG45110. The legal basis for this guidance is not specified but presumably, is Sections 59-59A, coupled with the spirit of SP D12. In short, this HMRC statement is semi-concessionary because Sections 59-59A are not this clear-cut, and SP D12 is not explicit. Firstly, the "look through" theory of both Sections (setting aside differences of drafting) is that partners/members of the entity are treated as owning or dealing in its underlying assets as partners, and not as simple co-owners. As discussed, a partner's interest in partnership property is not a simple percentage interest in that property. So one cannot simply say that a 75% interest in a partnership/UK LLP equates to owning 75% of its underlying assets, even if the partnership lacks legal personality. Secondly, even if Sections 59-59A did treat partners/members of the entity as co-owning its underlying assets, then that would leave each partner/member owning a fractional interest, but not all, of each underlying partnership asset (in the example above, part of each share of Company B). So technically, the partner/member would not own any of those partnership assets outright. Hence it would be hard to show that Company A owned 75% of the ordinary shares of Company B in order to establish a group relationship. This latter concern has apparently been raised by HMRC. It (though not the first concern) could be resolved more easily if, in the example, a direct subsidiary of A, Company C, held the remaining 25% interest in the partnership/ LLP. In that case, C's 25% part-interest in each of the B shares held by the partnership/LLP could be attributed to C's parent company, A, via the separate attribution rule in Section 1156 CTA 2010. A would then be treated as owning 100% of the ordinary shares of B.

A.8 *Limits on the transparency of partnerships and LLPs for corporation tax "group relief"*

Interestingly, HMRC published guidance is more detailed for the purposes of corporation tax "group relief" (which is separate from "grouping" when taxing chargeable gains). That guidance states that one can "look through" a partnership or a UK LLP to demonstrate a group relationship, as defined in Sections 131-133 CTA 2010: see the Corporation Tax Manual at CTM80152, which states that "A trading partnership In England, Wales or Northern Ireland has no legal personality and cannot own assets, so the assets of the partnership are treated as beneficially owned by the partners. This will generally be in proportion to the members' partnership shares, determined by the partnership agreement…." This guidance makes practical sense but glosses over the legal nature of a partnership share, even where a partnership lacks legal personality. It clearly cannot apply to a Scottish partnership[998].

For group relief purposes, there is no equivalent of Section 59 TCGA, which applies only in relation to partnerships and capital gains. For the same reasons, Section 59 does not apply in relation to the

[998] This is a problem because, as already discussed in 2.9.6, the courts are reluctant to interpret UK-wide tax legislation so as to produce different outcomes in Scotland compared to England, Wales and Northern Ireland.

corporation tax "grouping" rules for "loan relationships" and "intangible fixed assets" in Parts 5,6 and 8 CTA 2009.

In relation to UK LLPs only, Section 1273 CTA 2009 operates in a very similar way to Section 59A TCGA[999]. In particular, Section 1273(1) says:

> "For corporation tax purposes, if a limited liability partnership carries on a trade or business with a view to profit –
> (a) all the activities of the limited liability partnership are treated as carried on in partnership by its members (and not by the limited liability partnership as such),
> (b) anything done by, to or in relation to the limited liability partnership for the purposes of, or in connection with, any of its activities is treated as done by, to or in relation to the members as partners, and
> (c) **the property of the limited liability partnership is treated as held by the members as partnership property** [emphasis added].
>
> References in this subsection to the activities of the limited liability partnership are to anything that it does, whether or not in the course of carrying on a trade or business with a view to profit".

HMRC rely on the highlighted words to argue that "….for group relief purposes any ordinary share capital held by an LLP is treated as beneficially co-owned by the LLP members in accordance with each member's share in the LLP, and thus an LLP can be 'looked through' to establish a group relationship". One can see the practical merit of this statement, which seems inspired by SP D12. However, it is semi-concessionary because it is not legally accurate. Section 1273(1)(c) only says that the LLP members are treated as holding its assets as partnership property. Given the nature of a partner's interest in partnership property, a LLP member cannot simply be treated as owning a share of particular assets of the LLP corresponding to its LLP interest. Hence the additional points made earlier about the legal effect of Section 59A are equally relevant here.

Besides, as there is no Section 59 equivalent for the purposes of corporation tax group relief, it is much harder to "look through" a partnership other than a UK LLP, when defining a group relationship for group relief purposes. In this respect, HMRC guidance relies on the lack of legal personality of an English partnership as a basis for "looking through" it, without discussing the difficulties this raises, given the nature of a partnership interest. That guidance also fails to address how one can "look through", for these purposes, a partnership with legal personality, such as a Scottish partnership or a Delaware limited partnership. This seems especially hard, where there is no equivalent of Section 59, or of Section 1156 CTA 2010 (which applies a "look through" approach for certain purposes, but only to a body corporate). In the case of a Scottish partnership, partners do not beneficially own the entity's underlying assets, because Scottish property law has no concept of "beneficial", as opposed to "legal" ownership. Instead, they have a non-proprietary claim (a "ius crediti") against the partnership, which corresponds to their economic interest in it.

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[999] Section 1273(1)(c) is in fact the equivalent provision for corporation tax to Section 863 ITTOIA 2005 which was considered in *Bayonet Ventures* [2018] UKFTT 262 (TC). As the judge stressed in that case, Section 863 merely assimilates the position of LLP members to that of partners in a non-LLP partnership. It does not disregard the partnership or UK LLP.

A.9 *Limits on the transparency of partnerships and LLPs for the purposes of the "substantial shareholdings exemption" in Schedule 7AC TCGA*

A.9.1 *A "substantial shareholding"*

A similar question to the "grouping" question is whether one company can own a "substantial shareholding", via a partnership/UK LLP, in another company, for the purposes of the "substantial shareholdings exemption" ("**SSE**") from corporation tax on chargeable gains, in Schedule 7AC TCGA. The main definition of a "substantial shareholding" is in paragraph 8 of Schedule 7AC. In particular, paragraph 8(1) provides that "….a company holds a 'substantial shareholding' in another company if it **holds shares or interests in shares** [meaning a "co-ownership" interest in shares] in that company by virtue of which (a) **it holds not less than 10% of the company's ordinary share capital**….." [emphasis added]. Strictly speaking, it is hard to see how a company can "hold" a specified number of shares in another company merely by being a partner/ member of a partnership/ UK LLP which itself holds those shares. This is especially true if the entity is a separate legal person, such as a Scottish partnership or a UK LLP. For the reasons discussed above, it is doubtful whether Sections 59-59A "look through" the partnership/LLP sufficiently to cure this problem. The UK tax authorities may take a more relaxed position on this issue in practice, arguably relying on the spirit of SP D12[1000]. This is certainly an issue of which they are aware. Elsewhere in Schedule 7AC, for more limited purposes, language has been added quite recently to address this issue[1001].

A.9.2 *SSE: groups, subgroups and joint ventures*

Elsewhere in Schedule 7AC, concerns have surfaced about whether shares or an "interest in shares" can be owned via a partnership (whether or not having legal personality). Before looking at those concerns, it should be noted that paragraph 29 Schedule 7AC defines "an interest in shares" as "an interest as a co-owner of shares". Paragraph 29(2) then states that "It does not matter whether the shares are owned jointly or in common or whether the interests of the co-owners are equal". Paragraph 29(2) (and especially the words "jointly or in common") suggest that this definition of an "interest in shares" is quite narrow, being tied to the English law of co-ownership. This is odd because Schedule 7AC is not limited to shareholdings in UK-resident or UK-incorporated companies. By

[1000] If Schedule 7AD TCGA (see A.5 above) applies to a life insurance company's interest in a venture capital limited partnership, then the SSE cannot apply, even if the partnership itself holds a "substantial shareholding" in another company. This is because the partner can only ever accrue gain on the separate asset consisting of its partnership interest, which is not "looked through" where Schedule 7AD applies. That partnership interest is not itself a "substantial shareholding", even if it derives its economic value from such a shareholding.

[1001] Paragraph 3B(6) states that: "Where the assets of a partnership include ordinary share capital of a company, each partner is to be regarded as owning a proportion of that share capital equal to the partner's proportionate interest in that ordinary share capital". This deeming rule is not very clear about what a "proportionate interest" means. However, it presumably treats a partner as owning underlying ordinary share capital to the extent of its partnership share, as described in Section 2 of SP D12. It goes further than Sections 59-59A by equating a partnership share with ownership of partnership assets. Paragraph 3B(6)'s scope is limited: it only applies for the purposes of paragraphs 3A and 8A(1). In both paragraphs, it helps to work out the percentage ownership (via a partnership) by certain institutional investors of a company which itself owns a "substantial shareholding" in a second company. Hence, paragraph 3B(6) has no bearing on the main definition of a "substantial shareholding" in paragraph 8. If those institutional investors comprise life insurance companies investing via a "venture capital limited partnership" within Schedule 7AD (see A.5 above), it would be sensible to treat paragraph 3B(6) as a very limited exception to the non-"look through" treatment of partnership interests falling within Schedule 7AD. The legislation is not clear on this point.

contrast, in other parts of the tax legislation, "co-ownership" is expressly not restricted to its meaning under the law of any part of the UK: see, for example, the definition of an "offshore fund" in Section 355(3) TIOPA.

For SSE purposes, it can be very important to determine whether the company whose shares comprise the "substantial shareholding" is itself a member of a "trading group" or a "trading subgroup". Both these concepts are based on the Section 170 TCGA definition of a "group" for the purposes of corporation tax on capital gains (see paragraph 26 Schedule 7AC), but the required degree of affiliation is lowered to just over 50%. In the past, HMRC have argued that this level of affiliation can be traced through a partnership, but only if it lacks legal personality. Hence tracing through a Scottish partnership or a UK LLP is not possible. This position is out of line with current HMRC published guidance in the Capital Gains Manual at CG45110 (see above). That guidance seems to be based on Sections 59-59A TCGA, plus (?) SP D12. While Sections 59-59A may not strictly support that guidance, it gives a sound practical answer which, importantly, applies whether or not a partnership has legal personality. That preserves consistency of treatment between, in particular, Scottish and English partnerships.

The SSE also allows a corporate shareholder in certain joint venture companies to "look through" to the joint venture's underlying activities: see paragraphs 23-4 Schedule 7AC. This can help to show that the corporate shareholder is itself either a "trading company" or a member of a "trading group/subgroup", for SSE purposes. This "look through" is only possible where the corporate shareholder has a "qualifying shareholding", as defined in paragraph 24(2). If the corporate shareholder is not itself a member of a group, it can have a "qualifying shareholding" in the joint venture company "if, and only if, it **holds shares or an interest in shares** [emphasis added] in the joint venture company". If it is a member of a group, it can have a "qualifying shareholding" "if, and only if, it **holds ordinary share capital** [emphasis added] of the joint venture company".

There is no clear policy reason for the drafting difference highlighted above. Nevertheless, it appears that a corporate shareholder which is a group member can only have a "qualifying shareholding" if it directly "holds" ordinary share capital. "Looking through" a partnership of any kind is not possible for these purposes. If the corporate shareholder is not a member of a group, it has been argued that the reference to holding "an interest in shares" means that a "qualifying shareholding" can be traced through a partnership but only if it lacks legal personality. The author doubts if this is correct in practice, not least because of the "look through" in Sections 59-59A TCGA, which does not depend on whether or not a partnership has legal personality. However, a separate concern is the narrow definition (in paragraph 29) of an "interest in shares". Even with the benefit of Sections 59-59A, does a partner own partnership property "jointly or in common", given the unusual nature of a partnership share, even in a partnership which lacks legal personality? If the partnership has legal personality (e.g. a Scottish partnership) the problem becomes harder: in particular, a partner in a Scottish partnership has no property interest in the partnership's assets at all. One might invoke the spirit of SP D12 to bypass this problem in practice, which may explain why HMRC have been known to take a more relaxed stance on this issue[1002].

[1002] See also the discussion by Dominic Foulkes and Jonathan Cooklin in "Analysis – Holding shares through partnerships: some observations" Tax Journal, Issue 1415 at page 7 (5 October 2018). The author has doubts about statements in this article that SP D12 is broadly consistent with the strict legal position regarding the nature of a partnership interest, especially as the article only addresses interests in English general partnerships and not in UK LLPs or partnerships with legal personality (as in Scotland).

A.10 *Conclusion*

Partnerships are the quintessential example of a "transparent" entity. The UK rules on the transparency of partnerships and LLPs for the purposes of taxing chargeable gains take a fairly radical "look through" approach. Nevertheless, they leave much to be desired. Not only are they cumbersome to operate compliance-wise but the statutory rules underpinning this approach are limited and their effects unclear, not least when tracing affiliations between companies via intermediate partnerships and when applying the SSE. The void has been partly filled with non-statutory guidance. While the guidance often strives to give sensible practical answers and much of it is well-established, it is largely concessionary. Furthermore, HMRC practice in this area has not always been consistent. For both taxpayers and tax authorities, this is unsatisfactory, especially given how common partnerships are in the commercial world. A much more comprehensive legislative solution is needed.

If one were starting from scratch, a better approach would be the less radical approach to "transparency" in Schedule 7AD TCGA. By treating partnership interests as a separate asset for the purposes of taxing capital gains, the complex compliance issues associated with Sections 59-59A TCGA are greatly reduced. Furthermore, this would deal comprehensively with tax planning where base cost has been "shifted" tax-free from one taxpayer to another in reliance on Section 4 of SP D12, even though that Section is largely concessionary. This planning effectively allows one taxpayer to access the asset base cost of another, when computing its own chargeable gain. It was often used to reduce the effective tax rate on "carried interest" paid by funds to fund managers. Sections 103KA-KH TCGA have since 2015 targeted such planning but only in relation to the investment management industry (where such planning was widespread).

A Schedule 7AD-type approach alone would not be a complete solution. In particular, a separate "look through" rule would then be needed to trace relevant affiliations between companies via intermediate partnerships (although such a statutory rule is needed anyway). The non-"look through" Schedule 7AD-type approach would probably need to be overridden in particular cases e.g. to ensure that a non-UK-resident disposing of an interest in a non-UK partnership with a UK trading presence was taxable on a share of the partnership's unrealised gains on assets used for its UK trade.

Appendix B: corporation tax "transparency" where partnerships hold loan relationships, derivative contracts or intangible fixed assets.

B.1 *Partnerships and loan relationships, derivative contracts and intangible fixed assets*

The UK corporation tax code contains self-contained rules governing the corporation tax treatment of "loan relationships", "derivative contracts" and "intangible fixed assets".[1003] These rules were intended to modernise key aspects of the corporation tax system and, in particular, to more closely align corporation tax treatment with the GAAP accounting treatment of the relevant assets and liabilities. It is increasingly odd that these rules apply only for the purposes of corporation tax, given how similar many large partnerships are, in economic and functional terms, to companies.

The structure of these rules has caused difficulties when dealing with "loan relationships", "derivative contracts" and "intangible fixed assets" of entities which are "transparent" for corporation tax purposes[1004], and, in particular, partnerships. These problems are most marked when an interest in a partnership is transferred between corporation tax payers and that partnership holds intangible fixed assets.

The root cause of the problem is that TCGA typically does not apply to any assets which fall within Parts 5-8 CTA 2009[1005], even if those assets would otherwise be capital assets on general principles. Hence if loan relationships, etc are held by a partnership or by a "bare trust", the "look-through" rules in Sections 59, 59A and 60 TCGA are inoperative.

[1003] See Parts 5 and 6 CTA 2009 ("loan relationships"); Part 7 CTA 2009 ("derivative contracts") and Part 8 CTA 2009 ("intangible fixed assets"). Loan relationships cover in essence debts owed by and to corporation tax payers, although the rules have been significantly expanded to cover other instruments and arrangements with "debt-like" characteristics. "Derivative contracts" cover a wide range of financial derivatives e.g. swaps, futures and options. "Intangible fixed assets" cover a broad range of post-March 2002 intangible non-circulating assets (as defined by GAAP) as well as goodwill.

[1004] Meaning that the entity itself pays no corporation tax but its members are subject to corporation tax as if they took part directly in the underlying income-generating activities of the entity.

[1005] Parts 5-8 CTA 2009 ensure that profits and losses from "loan relationships", "derivative contracts" and "Intangible fixed assets" are typically recognised as income profits and losses, not capital gains and losses, for corporation tax purposes. There are exceptions for, in particular, certain "derivative contracts" and for intangibles in existence before April 2002, but these are immaterial for present purposes. Parts 5-8 CTA 2009 aim to cover exhaustively the tax treatment of "loan relationships", "derivative contracts" and "intangible fixed assets", unless expressly provided otherwise: see Sections 464, 699 and 906 CTA 2009. This means that TCGA is normally disregarded when taxing "loan relationships", "derivative contracts" and "intangible fixed assets".

B.2 *Partnership "look through" for loan relationships and derivative contracts*

In the rules regarding "loan relationships", Sections 380-5 CTA 2009 (first enacted in 2004[1006]) introduce a form of "look-through", treating corporation tax-paying partners as if they were party to the underlying debts owed by or to the partnership. There are similar rules regarding such partners in a partnership which enters into "derivative contracts": see Sections 619-621 CTA 2009. These rules aim to "look through" the partnership more directly than the normal UK rules determining how a partnership's income (but not its capital gain) is to be taxed on a "transparent" basis. Those normal rules, for corporation tax payers, are set out in particular in Sections 1259-60 CTA 2009 and do not treat partners as party to the underlying assets and liabilities of the partnership. In other words, there is no simple "look through"[1007]. Instead, a computation of income profit or loss is made on the assumption, for computational purposes only, that the partnership is a company. An appropriate amount of this profit or loss is then allocated to the corporate partner consistently with the partnership's profit-sharing arrangements, under Section 1262 CTA 2009. That partner is liable for corporation tax on any profit allocated to it in this way.

If there are both UK-resident and non-UK-resident partners, then two separate computations of profit or loss are made under Sections 1259-60. The first assumes that the partnership is itself a UK-resident company and the second that it is a non-UK-resident company. The first computation is used to allocate profit or loss to each UK-resident partner. The second computation is used to allocate profit or loss to each non-UK-resident partner[1008]. Those partners are then liable for corporation tax accordingly.

B.3 *Partnerships: limited "look through" for intangible fixed assets*

However, if a partnership owns intangible fixed assets, no rule treats a corporation tax-paying partner as owning a fractional interest in each of those underlying assets for the purposes of Part 8 CTA 2009. Furthermore, Section 807(1)(c) CTA 2009 provides that "the interest of a partner in a firm" cannot itself fall within the "intangible fixed asset" rules, unless under UK GAAP, it falls to be treated as representing an interest in partnership property which is an "intangible fixed asset" for Part 8 CTA 2009 purposes[1009]. Such treatment under UK GAAP is not a foregone conclusion[1010].

[1006] Prior to 2004, there had been a number of attempts to achieve tax advantages by exploiting the lack of a "look through": see the (obsolete and withdrawn) Statement of Practice 4/98.

[1007] In particular, following *Investec Asset Finance PLC, Investec Bank PLC v HMRC* [2020] EWCA Civ 579, the effect of these rules seems to be that any trade carried on by the partnership is a separate trade for tax purposes from the business activities of the partners (including any separate trading activities) outside the confines of the partnership. Furthermore, income of the partnership trade computed at partnership level (and allocated to partners as described above) is ignored when computing any separate tax liability of the partners from their activities outside the partnership. Hence there can be no double taxation of partnership income.

[1008] Where partners in a partnership are not subject to corporation tax, there are equivalent rules (in particular, Sections 849-850 ITTOIA) for computing at partnership level the income profits and losses of the partnership for UK income tax purposes, and for allocating them to the partners. Again, these rules do not "look through" the partnership so as to treat partners as holding its underlying assets and liabilities. Their approach is therefore different to that of Sections 59-59A TCGA: see Appendix A.

[1009] Section 807(3) CTA 2009. Section 807(2) is an equivalent exception for rights under a trust, which otherwise cannot be "intangible fixed assets" for Part 8 purposes.

[1010] For further discussion, see the First-Tier Tribunal in *Armajaro Holdings Limited v HMRC* [2013] UKFTT 571 (TC). That case focussed mainly on questions arising in relation to the purchase of an interest in a UK LLP holding

This potential lack of "transparency" can have important consequences if an interest in a partnership is sold from one corporation tax-payer to another. Suppose that A Ltd and B Ltd are partners in a partnership whose assets comprise valuable intangibles. They share profits in the ratio 30:70. A Ltd sells its 30% interest to C Ltd. C Ltd has "acquired" economically a large slice of the underlying intangibles. However, the lack of "transparency" means that C Ltd is unable to claim depreciation for tax purposes[1011] in respect of the underlying intangibles.

The corporation tax treatment of A Ltd is also odd. The potential lack of "transparency" in Part 8 CTA 2009 means that it may well not be treated as selling a slice of the underlying intangibles. Any profit it makes will therefore not be taxed as income under Part 8, even though that profit reflects growth in the value of "intangible fixed assets". Furthermore, that profit will not be taxed as capital gain either, because of the way in which TCGA analyses an interest in a partnership. As discussed in Appendix A, Section 59 TCGA, together with SP D12, treats a partner, for the purposes of corporation tax on chargeable gains, as owning a proportionate share in each asset of the partnership. Hence, one ignores the partnership interest as a separate asset and "looks through" it to the partnership's underlying assets. However, in this case, those assets consist of intangibles which ordinarily fall within Part 8 CTA 2009. To treat A Ltd as disposing, for TCGA purposes, of a 30% interest in the underlying intangibles would be at odds with Section 906 CTA 2009. In particular, subject to any contrary indication[1012], "The amounts to be brought into account in accordance with [Part 8 CTA 2009] in respect of any matter are the only [emphasis added] amounts to be brought into account for corporation tax purposes in respect of that matter". There does not seem to be "any contrary indication" to displace this rule. The fact that the amount "brought into account" under part 8 is in fact nil, rather than a tiny positive amount, should not prevent Section 906 from applying. Otherwise, the goal of dealing with most intangible fixed assets exclusively under Part 8 CTA 2009 would be undermined.

Part 8 CTA 2009 contains no "look through" rule similar to those which apply to the "loan relationships" and "derivative contracts" of partnerships. Therefore, on the sale of a partnership interest, (i) gains of the corporate seller attributable to underlying intangible fixed assets of the partnership may not be taxed under Part 8; and (ii) the purchaser of that interest may not get effective amortisation relief for that part of the purchase price which is referable to those intangibles[1013]. This analysis is consistent with the way in which HMRC used to treat a disposal by a

intangible fixed assets. However, expert accounting evidence was presented that if a controlling interest in a general partnership was acquired, then UK GAAP would permit this to be presented as acquiring underlying goodwill of the partnership on the basis of "proportional consolidation". The same accounting treatment was not possible when an interest in a UK LLP was acquired, because the latter is a separate legal person. This conclusion seems (?) to create an unfortunate distinction between Scottish and English general partnerships, because the former are also separate legal persons.

[1011] Either on an accounting basis under Section 729 CTA 2009 or by electing to write down at 4% per annum under Sections 730-1 CTA 2009.

[1012] Section 906(2) CTA 2009

[1013] There is limited, unsatisfactory discussion of this issue by the First-Tier Tribunal in *Bloomberg Inc (UK permanent establishment), BLP Acquisition Holdings LLC (UK permanent establishment) v HMRC* [2018] UKFTT 205 (TC), in particular at paras 149-156. Both HMRC and the judge did not explore in detail the implications of Section 59 TCGA not applying because of Section 906 CTA 2009, when an interest is sold in a partnership holding intangible fixed assets. Counsel for HMRC even suggested that a purchaser of a partnership interest would acquire a base cost in that interest for the purposes of TCGA, if the intangible fixed assets rules did not corporate seller of an interest in a partnership holding "loan relationships" or "derivative contracts": see paragraphs 13 and 21 of the old Statement of Practice 4/98. That treatment no longer applies because of the explicit "look through" rules (see B.2 above) regarding a partnership's "loan relationships" and "derivative contracts".

If the partnership itself earns income (e.g. royalties) from dealing with its underlying intangible fixed assets, then, for the purposes of Part 8 CTA 2009, partnership profits from those dealings will be computed as income on the assumption that the partnership is itself a company subject to corporation tax[1014] and which owns those assets. Those profits (i.e. the overall result) will then be apportioned among partners subject to UK corporation tax according to the profit-sharing arrangements for the relevant period: see B.2. There will be no tax on any such profits at the level of the partnership itself. To that extent, the partnership is "transparent" for the purposes of Part 8 CTA 2009. However, this extends only to dealings of the partnership itself with its intangible fixed assets, but not to dealings by the partners with their own partnership interests.

B.4 *Conclusion*

It would be wise to include in Part 8 CTA 2009 a "look through" rule for partnerships holding "intangible fixed assets" which is similar to the "look through" rules which already apply to partnerships in respect of their "loan relationships" and "derivative contracts". It is unsatisfactory that the current position depends on Section 807 CTA 2009.

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apply because of Section 807(1)(c) CTA 2009. This suggestion is hard to understand: Section 59 TCGA (unlike Schedule 7AD TCGA – see Appendix A) does not treat a partnership interest as an asset in its own right but looks through (with the assistance of SP D12) to the assets underlying that interest. If those assets would be "intangible fixed assets" for Part 8 CTA 2009 purposes, then taxing a transfer of the partnership interest under TCGA would involve "bringing into account an amount in respect of a matter" (i.e. those intangibles) contrary to Section 906 CTA 2009. There does not seem to be any way to "switch off" Section 59, and to treat the partnership interest as a separate asset for TCGA purposes, simply because the underlying partnership assets are "intangible fixed assets" within Part 8 CTA 2009.

[1014] Sections 1258-1260 CTA 2009.

Appendix C: Entity classification issues in the UK's estate and gift tax treaties

The UK has a limited number of bilateral treaties aimed at avoiding or reducing the double taxation of gifts and inheritances. Many of these agreements are quite old. This section outlines the extent to which those les well-known agreements have addressed possible disagreements over entity classification.

C.1 *Older estate tax agreements*

The older agreements tend not to address entity classification mismatch issues at all. Instead, they usually set out special rules for determining the "situs" of particular types of asset, for the purposes of allocating taxing rights between the contracting states. It is common for a state to have taxing rights over assets whose "situs" is in that state. The special rules in the older agreements can lead to a more favourable outcome for the taxpayer than if the "situs" of assets was left to be decided under the domestic law of each state. Those special "situs" rules can, however, cause entity classification mismatch issues. For example, Article IV of the UK-Italy treaty of 1968[1015] provides, in Article IV(6), that shares, stock or debentures in a "company" (which is not defined) "shall be deemed to be situated at the place where the company was incorporated", regardless of where it actually does business. However, Article IV(7) then says that "An interest in a partnership shall be deemed to be situated at the place where the business was carried on; and if the business was carried on at more than one place an appropriate proportion of the interest shall be deemed to be situated at each of those places". "Partnership" is not defined either, yet the tax outcome, in terms of the "situs" of an interest in a business entity, may differ significantly depending on whether it is a "company" or a "partnership". There is no guidance on how a partnership interest should be apportioned under Article IV(7).

Article IV of the UK-France treaty of 1963[1016] takes a similar approach to the UK-Italy treaty but with some important differences. Shares (but not debentures) in a "company" are situated where the "company" is incorporated: see Article IV(e). However, under Article IV(g), "an interest in a partnership, which includes a societe en nom collectif, a societe en commandite simple and a societe civile under French law, shall be deemed to be situated at the place where the business is principally carried on [emphasis added] and in the case of a societe civile immobiliere, this shall be where the land developed in accordance with the objects of the societe is located".

[1015] SI 1968/304.
[1016] SI 1963/1319.

Hence the UK-France treaty partially defines a "partnership" (the UK-Italy treaty does not) and includes in that definition a French entity (the "societe civile") which the UK would not normally regard as akin to a partnership. In particular, the HMRC list of non-UK entities in INTM 180030 (produced long after 1963) states that a "societe civile" is not regarded as "transparent" for the purposes of UK taxation of income and gain.

The UK-France treaty, unlike the UK-Italy treaty, does not envisage an interest in a partnership being situated in more than one place, although the place where it is situated is not where the partnership is formed but where its business is "principally carried on". This differs from the rule which makes the place of incorporation of a "company" (and where it carries on business) the "situs" of its shares.

These older agreements leave "company" and "partnership" largely undefined. "Unless the context otherwise requires", otherwise undefined terms are to have the meaning they have under the law of the relevant treaty party "relating to the duties which are the subject of the Convention": see, for example, Article 11(3) of the UK-Italy treaty. If the domestic tax rules of a treaty party are to determine the nature of an entity for the purposes of applying the treaty's special situs rules, there is clearly considerable scope for disagreement. This can lead to either double taxation with no effective relief or to unintended double non-taxation.

C.2 *Newer estate tax agreements*

C.2.1 *Introduction*

The UK has a number of estate and gift tax agreements which take a more modern approach, in broad conformity with the 1982 OECD Model Double Taxation Convention on Estates and Inheritances and Gifts ("the 1982 Model")[1017]. Those more modern treaties include in particular those with the US[1018], Switzerland[1019] and the Netherlands[1020]. They also include a treaty with South Africa[1021] and with Sweden[1022], although it is understood that Sweden no longer imposes estate and gift taxation.

Broadly, these more modern agreements allocate exclusive taxing rights to the jurisdiction in which the relevant person is "domiciled" (as defined by reference, initially, to the domestic law of the two jurisdictions but with recourse to a "tie-breaker" where dual domicile would otherwise result). However, these exclusive taxing rights are subject to the taxation rights of the jurisdiction where certain types of asset are situated. Those assets include, in particular, "immovable property" as well as assets forming part of the business property of a "permanent establishment of an enterprise" or "assets pertaining to a fixed base used for the performance of independent personal services". If

[1017] https://legalinstruments.oecd.org/public/doc/82/82.en.pdf (accessed 30 June 2020).
[1018] SI 1979/1454.
[1019] SI 1994/3214. The agreement with Switzerland in fact tracks the 1982 Model less closely than the other more modern treaties, especially where recourse to a tie-breaking rule is needed to avoid dual domicile. For a fuller discussion, see John F. Avery Jones: "The new inheritance tax double taxation agreement with Switzerland" [1995] BTR 1.
[1020] SI 1980/706 (as amended).
[1021] SI 1979/576.
[1022] SI 1981/840 (as amended).

assets end up being taxed in both jurisdictions, then the agreement will provide for double taxation relief by way of credit (although the 1982 Model envisages such relief by either credit or exemption).

C.2.2 *"Immovable property"*

The treaties concerned contain a fairly limited definition of "immovable property". In particular, this term is stated to have the meaning which it has under the law of the contracting state where the relevant property is situated. It also includes various rights relating to landed property, such as the right to payments for working mineral deposits or other natural resources. Unlike the earlier estate tax treaties, there is no special definition of "situs". The definition of "immovable property" is also not expanded to include interests (e.g. shares) in a "property-rich entity", in contrast to the OECD Model. However, this last situation may be covered by implication if the domestic law of the jurisdiction where the underlying real estate is situated, treats interests in the real estate-holding entity as "immovable property".

C.2.3 *"Permanent establishment"*

All more modern treaties contain a definition of "permanent establishment" which resembles that in pre-2017 versions of the OECD Model. The OECD Model no longer has a separate article dealing with income from independent personal services, making the "fixed base" concept redundant in that Model.

The UK agreements with the Netherlands, Sweden and Switzerland (but not with the US) explicitly expand the "permanent establishment" definition to deal with "partnerships" (which are not defined). For example, Article 6(7) of the UK-Netherlands agreement states that "The provisions of paragraphs 1 and 6 of this Article shall apply to an interest in a partnership if an enterprise is carried on or independent professional services are performed, by the partnership". This somewhat obscure wording seems to have been inspired by paragraph 26 of the Commentary on Article 7 of the 1982 Model[1023]. It presumably means that, if a partnership has a "permanent establishment" or fixed base in a jurisdiction, then that jurisdiction in particular can tax assets of that establishment or base when an event arises which triggers tax on an interest in the partnership. Hence, the holder of the partnership interest is treated as carrying on business in that jurisdiction through the "permanent establishment" or "fixed base". Furthermore, the other jurisdiction will respect that analysis for its own tax purposes (in particular, granting a credit for tax in the jurisdiction where the establishment or base is located). This rule regarding interests in a partnership should limit unrelieved double taxation, or double non-taxation, when that partnership interest passes on death or by way of a lifetime gift.

The agreements with the Netherlands, Sweden and Switzerland do not define a "partnership" for these purposes. Therefore, "unless the context otherwise requires", one must prima facie apply the meaning of that term under the inheritance and gift tax law of the jurisdiction which is seeking to apply this rule regarding partnerships: see, for example, Article 3(2) of the UK-Netherlands agreement and of the UK-Switzerland agreement. This clearly leaves scope for one jurisdiction to treat as a "partnership" an entity which would not be so regarded by the other jurisdiction. Hence, while Article 6(7) of the UK-Netherlands agreement is helpful, entity classification mismatches may still arise e.g.

[1023] https://read.oecd-ilibrary.org/taxation/model-double-taxation-convention-on-estates-and-inheritances-and-on-gifts_9789264177277-en#page1 (accessed April 2020).

relating to a Dutch limited partnership, known as a "commanditaire venootschap" or "CV". This entity[1024] lacks legal personality and is therefore always regarded as "transparent" for UK tax purposes: see the HMRC guidance in the International Tax Manual at INTM 180030. It is also likely to be regarded as a partnership for UK tax purposes. However, if interests in a CV can be transferred without the consent of the other CV members, it will be regarded as a company, and hence "opaque" in relation to its limited partners, for Dutch tax purposes: a so-called "open CV". Suppose that a Dutch limited partner in an "open CV" transfers on death an interest in the CV at a time when it has a UK "permanent establishment". On the basis of the UK domestic law definition of "partnership", the UK is likely to rely on Article 6(7) of the UK-Netherlands agreement so as to impose inheritance tax on a deemed transfer of the underlying assets of the UK "permanent establishment". The amount of that deemed transfer will reflect the extent of the donor's interest in the CV. However, under Dutch domestic law, the interest in the "open CV" will not be regarded as an interest in a partnership. So the Netherlands may not accept that Article 6(7) of the UK-Netherlands agreement applies. In that case, and subject to Article 9 (see C.2.6), the Netherlands may not be willing to give double taxation relief for any UK tax imposed on the transfer of the CV interest, on the basis of Article 6(7).

It would also be helpful if Article 6(7) of the UK-Netherlands agreement, and equivalent provisions in other agreements, was not limited to partnerships. In particular, it would make sense for it to apply to a vested interest in a trust.

C.2.4. *Other types of property*

Some of the more modern agreements contain allow ships and aircraft engaged in international traffic to be taxed in the jurisdiction where the "effective management" of the relevant enterprise is located: see the agreements with South Africa, Switzerland, Sweden and the Netherlands. In the case of Sweden and the Netherlands (but, oddly, not Switzerland), this special rule also covers boats engaged in inland waterways transport.

The South African agreement also allows the shares and debentures of a "company" (undefined) to be taxed in the contracting state where the company is incorporated. Similarly, units in a unit trust scheme may be taxed in the contracting state where the register of unitholders is kept. This special rule regarding shares and debentures of a company[1025] could give rise to double taxation or unintended double non-taxation if there was disagreement about whether a particular entity was a "company". However, this risk should be reduced by Article 9 of the South African agreement (see C.2.6).

C.2.5 *Settlements*

The Commentary to Article 1 of the 1982 Model recognises that bespoke treaty provisions may be needed to accommodate specific property holding arrangements such as trusts, foundations and usufructs. The 1982 Model does not deal with these arrangements in detail, leaving these issues to bilateral negotiations. This is a significant gap given the widespread use of such arrangements for

[1024] See also 7.3.2.
[1025] In the UK-Switzerland agreement, the UK has a secondary taxing right over shares in a UK-incorporated company, in cases where that agreement regards the deceased as "domiciled" in Switzerland without needing to have recourse to any tie-breaker.

wealth planning purposes, and the very different estate and gift tax regimes used by states to tax such arrangements.

Surprisingly, the various UK estate and gift tax agreements only deal to a limited degree with the taxation of "settlements". In particular, the older treaties say little or nothing about them[1026]. The newer treaties tend not to deal explicitly with "settlements" where the settlor was not "domiciled" in either contracting state, when the settlement was made.

The UK agreements with the Netherlands and Switzerland purport to apply (see Article 1 in each case) to property comprised in "settlements" made by persons domiciled in either contracting state when the settlement was made. However, little more is then said in each agreement. If a settlement is created by a Dutch-domiciled settlor and contains UK property such as shares of a UK-incorporated company, the usual UK IHT charges on that settlement are largely excluded by Article 11(2).

By contrast, if the settler was domiciled in a contracting state other than the UK when the settlement was created, the UK treaties with the US, South Africa and Sweden tend to exclude the settlement from UK taxation, subject to reserving UK taxing rights in respect of immovable property, etc[1027]. This is a generous open-ended carve-out, although there is nothing equivalent if, say, the settlor is not domiciled in that other contracting state but all the beneficiaries are. There is also no rule in these three treaties which excludes non-UK taxation of settled property where the settlor was domiciled in the UK when the settlement was created.

"Settlement" is usually not expressly defined for these purposes. Presumably, "unless the context otherwise requires", the UK's expanded definition of "settlement" (for inheritance tax purposes) is likely to apply, to the extent that the relevant treaty affects UK taxing rights. As discussed in 5.3.2, this definition of "settlement" is not limited to trusts. This feature alone may give rise to disputes over interpretation and taxation mismatches, because the "settlement" definitions of the UK and the other state are unlikely to be symmetrical.

C.2.6 *Anti-mismatch rule*

To resolve classification mismatches regarding the nature of property, the UK agreements with the Netherlands, South Africa, Sweden and Switzerland (but not the agreement with the US) contain an additional rule. In the UK-Netherlands agreement, this is headed "Conflict as to the nature of property" (Article 9) and reads:

> "If, by the law of one of the States, any right or interest is regarded as property not falling within any of Articles 5 [immovable property], 6 [property of a permanent establishment or fixed base] and 7 [ships and aircraft], but by the law of the other State, that right or interest is regarded as property falling within those Articles, then that right or interest shall for the purposes of this Convention be regarded as property falling within those Articles".

[1026] See Article V(2) of the UK-Italy agreement for a limited reference to settlements in the context of fixing rates of taxation. Article V(1)(b) of the 1957 agreement with Pakistan (SI 1957/1522) preserves Pakistani taxing rights in respect of settled property containing a life interest, where the settlor was domiciled in Pakistan when the settlement was created.

[1027] See Article 5(4) of the UK-US agreement; Article 5(2) of the UK-South Africa agreement; and Article 5(4) of the UK-Sweden agreement.

The equivalent rule in the UK-Switzerland agreement (Article 10(1)) is very similar although it does not apply to lifetime gifts (which are generally not covered by that agreement). In the agreements with Sweden and South Africa, the equivalent rule is Article 9, which only applies where the deceased or the transferor (as the case may be) is “domiciled” in one of the contracting states for the purposes of the agreement. If the deceased/transferor is “domiciled” in neither of those states, and both states would still seek to tax the same property on the basis of “situs”, then the competent authorities of the two states are to attempt to resolve that “situs” question.

This kind of rule is likely to resolve the classification mismatch in a manner which increases the allocated taxing rights of the jurisdiction where the property is situated.

This type of rule is inspired by, though not identical to wording suggested in paragraph 24 of the Commentary on Article 7 of the 1982 Model. If one applies Article 9 of the UK-Netherlands agreement to the earlier example of the “open CV”, then both the UK and the Netherlands must apply the UK analysis that the interest in the CV comprises property of a UK “permanent establishment”, relying in part on Article 6(7) of the UK-Netherlands agreement. Hence the UK should get to tax a proportion of the property of that UK establishment and the Netherlands should give double taxation relief for that UK tax.

The UK-Ireland agreement contains a modified version of this type of rule in Article 6(2). Despite being a more modern agreement, this agreement differs significantly from the 1982 Model[1028]. It is an unusual agreement which is not considered in greater detail here.

C.2.7 *Conclusion on UK estate and gift tax agreements*

Although they can give rise to significant entity classification mismatch issues, the UK’s estate and gift tax agreements are a fairly neglected backwater. There seem to be no plans to expand their number nor does overhaul of the existing agreements seem to be a priority, especially when contrasted with the work which has led to Article 1(2) of the OECD Model and Article 3 of the MLI. In particular, a number of these agreements are old and do not even conform to the 1982 Model and Commentary, which go some way towards addressing mismatch issues. The approach to taxing estates, gifts and settlements can vary a lot between jurisdictions, not least in relation to trusts and foundations. This makes it harder to conclude such agreements. Nevertheless, it would make sense for the UK to bring its older agreements at least into line with, in particular, its agreement with the Netherlands. The UK has a large population of high net worth expatriates (many of whom are French and Italian) and the yield from UK inheritance tax has been rising steadily. Furthermore, reform of the UK’s rules for taxing wealth transfers is moving up the political agenda. Therefore, it would make sense to upgrade its estate and gift tax agreements, so as to reduce double taxation or unintended double non-taxation. This would also be consistent with EU Commission Recommendation 2011/856/EU of 15 December 2011, which deals with relief for double taxation of inheritances.

[1028] SI 1978/1107.

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